United States General Accounting Office

# GAO

Report to the Secretary of the Treasury

February 2002

# FINANCIAL AUDIT

# IRS's Fiscal Years 2001 and 2000 Financial Statements

GAO

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**Supplementary Notes**

**Abstract**
The accompanying report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) as of and for the fiscal years ending September 30, 2001, and 2000. Our audits were required by the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRSs financial statements, (2) opinion that IRSs internal controls were not effective as of September 30, 2001, and (3) report on IRSs noncompliance with one provision of laws and regulations that we tested and IRSs financial management systems lack of substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

**Subject Terms**

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## Abbreviations

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| EITC | earned income tax credit |
| FFMIA | Federal Financial Management Improvement Act of 1996 |
| FFMSR | Federal Financial Management Systems Requirements |
| FIA | Federal Managers' Financial Integrity Act of 1982 |
| IRS | Internal Revenue Service |
| JFMIP | Joint Financial Management Improvement Program |
| OMB | Office of Management and Budget |
| P&E | property and equipment |
| SGL | *U.S. Government Standard General Ledger* |
| TIGTA | Treasury Inspector General for Tax Administration |

G A O
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, D.C. 20548

February 27, 2002

The Honorable Paul H. O'Neill
The Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) as of and for the fiscal years ending September 30, 2001, and 2000. Our audits were required by the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRS's financial statements, (2) opinion that IRS's internal controls were not effective as of September 30, 2001, and (3) report on IRS's noncompliance with one provision of laws and regulations that we tested and IRS's financial management systems' lack of substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

Our unqualified opinions on IRS's fiscal years 2001 and 2000 financial statements were made possible by the extraordinary efforts of IRS senior management and staff to compensate for serious internal control and systems deficiencies. However, even with these efforts, IRS found it extremely difficult to meet the February 27 reporting timeline required by the Office of Management and Budget (OMB) for fiscal year 2001, which is 5 months after the fiscal year end. OMB has announced the executive branch's intention to significantly accelerate this timeline in future years. Beginning with fiscal year 2004, IRS will be required to issue its financial statements by November 15, or 6 weeks after the fiscal year end. Also, the Department of the Treasury has established a goal of completing its fiscal year 2002 audit, including those of its component entities, and issuing its department wide accountability report by November 15, 2002. If IRS is to meet this deadline and sustain an unqualified opinion on its financial statements, the tremendous amount of hard work and commitment IRS has demonstrated in recent years will no longer be sufficient to achieve this goal unless accompanied by systemic changes in how IRS processes transactions, maintains its financial records, and reports its financial results. At present, IRS continues to lack timely, accurate, and useful financial information and sound controls with which to make fully informed decisions and to ensure ongoing accountability. IRS is continuing to work to address its serious control and systems deficiencies.

The accompanying report also discusses other significant issues that we considered in performing our audit and in forming our conclusions that we believe should be brought to the attention of IRS management and users of IRS's financial statements.

We are sending copies of this report to the chairmen and ranking minority members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Governmental Affairs; Senate Committee on the Budget; Subcommittee on Treasury, General Government, and Civil Service, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; Subcommittee on Oversight of Government Management, Restructuring, and the District of Columbia, Senate Committee on Governmental Affairs; House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government Reform; House Committee on the Budget; Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, House Committee on Government Reform; and Subcommittee on Oversight, House Committee on Ways and Means. In addition, we are sending copies of this report to the chairman and vice-chairman of the Joint Committee on Taxation, the commissioner of internal revenue, the director of the Office of Management and Budget, the chairman of the IRS Oversight Board, and other interested parties. Copies will be made available to others upon request.

This report was prepared under the direction of Steven J. Sebastian, Acting Director, Financial Management and Assurance, who can be reached at (202) 512-3406. If I can be of further assistance, please call me at (202) 512-5500.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Comptroller General
of the United States

United States General Accounting Office
Washington, D.C. 20548

To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994, this report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) for fiscal years 2001 and 2000.[1] The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity related to IRS's administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the amount of taxes owed the federal government but which have not been identified by IRS, often referred to as the "tax gap."

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. The size and complexity of IRS's operations present additional challenges to management. IRS is a large, complex, organization with about 100,000 people in 10 service center campuses, 3 computing centers, and numerous other field offices throughout the United States. Historically, other than headquarters, most IRS offices have had responsibilities tied to their geographical locations. However, in response to congressional concerns about IRS's operations embodied in the Internal Revenue Service Restructuring and Reform Act of 1998, IRS underwent a reorganization that significantly affected the previous roles and responsibilities of these offices. In fiscal years 2001 and 2000, IRS collected over $2 trillion in tax payments, processed over 210 million tax returns, and paid about $251 billion and $194 billion, respectively, in refunds to taxpayers. Refunds paid during fiscal year 2001 included about $36 billion in advance payments (i.e., tax rebates) of tax year 2001 tax credits disbursed in accordance with the Economic Growth and Tax Relief Reconciliation Act of 2001 (26 U.S.C. §6428).

[1]IRS significantly changed its cost classification structure during fiscal year 2001 and was unable to restate fiscal year 2000 balances for purposes of comparability. Consequently, IRS is not presenting a comparative fiscal year 2000 statement of net cost. IRS received a waiver from this reporting requirement from the Office of Management and Budget.

One of the largest obstacles facing IRS management today is that the agency still does not have a financial management system capable of producing reliable and timely information its managers need to make day-to-day decisions. Because of this systems issue and other factors, it continues to face many of the pervasive internal control weaknesses that we have reported each year since we began auditing IRS's financial statements in fiscal year 1992.[2] Nevertheless, in fiscal year 2001, for the second consecutive year, IRS was able to produce financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects. However, because of its serious systems and control weaknesses, IRS was again compelled to rely extensively on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts that extended nearly four months after the September 30, 2001, fiscal year-end to derive reliable year-end balances for its financial statements. These costly efforts would not have been necessary if IRS's systems and controls operated effectively. It is also important to note that this approach cannot produce the reliable, useful, and timely financial and performance information IRS needs for decision-making on an ongoing basis, which is a goal of the CFO Act, nor can it fully address the underlying financial management and operational issues that adversely affect IRS's ability to effectively fulfill its responsibilities as the nation's tax collector. We reported on these continuing significant challenges for IRS in our high-risk and performance and accountability series[3] and other reports.

[2]U.S. General Accounting Office, *Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements*, GAO/AIMD-93-2 *(Washington, D.C.:* June 30, 1993).

[3]U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.; January 2001) and U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of the Treasury,* GAO-01-254 (Washington, D.C.: January 2001).

Strong commitment and hard work by both IRS senior leadership and staff continues to be the key to IRS's ability to overcome its fundamental systems and internal control deficiencies and achieve its goal of receiving unqualified audit opinions on its financial statements for fiscal years 2001 and 2000. However, IRS found it extremely difficult to prepare its financial records for audit examination and issue its financial statements within the reporting timeline required by the Office of Management and Budget (OMB) for fiscal year 2001. OMB has announced the executive branch's intention to significantly accelerate this timeline for future years and by fiscal year 2004, IRS will be required to issue its financial statements by November 15, or 6 weeks after fiscal year end. Also, the Department of the Treasury has established a goal of completing its fiscal year 2002 audit, including those of its component entities, and issuing its department wide accountability report by November 15, 2002. If IRS is to meet this deadline while sustaining an unqualified opinion on its financial statements, the tremendous amount of hard work and commitment IRS has demonstrated in recent years will no longer be sufficient unless it is accompanied by significant and systemic changes in how IRS processes transactions, maintains its records, and reports its financial results. This year, IRS made notable progress in a number of areas and has laid the groundwork for sustainable improvements in several others. For example, IRS has made important progress in addressing deficiencies in its controls over budgetary activity, accountability over property and equipment, and computer security. At the same time, further actions are needed and we continue to consider these issues to be material weaknesses.[4]

The challenge for IRS will be to continue the improvements made in recent years. This not only means continuing to improve its compensating processes but, more importantly, to develop and implement the fundamental long-term solutions that are needed to address the internal control weaknesses we have identified. Some of these solutions can be addressed in the near term through the continued efforts and commitment of IRS senior management and staff. Others, which involve modernizing IRS's financial and operational systems, will take years to fully achieve.

[4]A material weakness is a condition that precludes the entity's internal controls from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis. Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS's ability to meet the objectives described in this report.

## Opinion on IRS's Financial Statements

IRS's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, net position, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity, as of and for the fiscal years ended September 30, 2001, and September 30, 2000, and IRS's net costs for the fiscal year ended September 30, 2001.

However, misstatements may nevertheless occur in other financial information reported by IRS as a result of the internal control weaknesses described in this report.

IRS's financial statements report tax revenues collected during the fiscal year and the cumulative amounts of unpaid taxes where there is agreement with IRS, either by the taxpayer or court, as to the amounts owed. Cumulative unpaid tax assessments for which there is no future collection potential or where there is no agreement as to the amounts owed are not reported in the financial statements, but are reported as write-offs and compliance assessments, respectively, in supplemental information to IRS's financial statements. However, to the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs, in accordance with U.S. generally accepted accounting principles, they are not reported in the financial statements nor in supplemental information to the financial statements. As IRS discusses in the other accompanying information to the financial statements, IRS does not have current information upon which to base a reasonable estimate of the magnitude of these unidentified and unpaid taxes—referred to as the "tax gap". We have discussed this issue in our high-risk series.[5]

## Opinion on Internal Controls

Because of the material weaknesses in internal controls discussed below, IRS did not maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. 3512 (c), (d), the Federal

[5] GAO-01-263.

Managers' Financial Integrity Act of 1982 (FIA), and OMB's Circular A-123, *Management Accountability and Control.*

Despite its material weaknesses in internal controls and its system deficiencies, IRS was able to prepare, through compensating processes and approaches, financial statements that were fairly stated in all material respects for fiscal years 2001 and 2000. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal controls:

- an inadequate financial reporting process, resulting in IRS not (1) being able to prepare reliable financial statements without extensive compensating procedures or (2) having current and reliable ongoing information to support management decision-making and to prepare cost-based performance measures;
- weaknesses in controls over unpaid tax assessments, resulting in IRS's inability to properly manage unpaid assessments and leading to increased taxpayer burden;
- weaknesses in controls over the identification and collection of tax revenues due the federal government and the issuance of tax refunds, resulting in potentially billions of dollars in improper payments and lost revenue to the federal government;
- inadequate controls over property and equipment, resulting in IRS's inability to reliably and timely report its property and equipment balances and reasonably ensure that its property and equipment is safeguarded and used only in accordance with management policy;
- weaknesses in controls over budgetary activity, resulting in IRS's inability to routinely ensure that its budgetary resources are being properly accounted for, reported, and controlled; and
- weaknesses in computer security controls, potentially resulting in unauthorized individuals being allowed to access, alter, or abuse proprietary IRS programs and electronic data and taxpayer information.

The material weaknesses in internal controls noted above may adversely affect any decision by IRS's management that is based, in whole or in part, on information that is inaccurate because of these weaknesses. In addition, unaudited financial information reported by IRS, including budget and performance information, may also contain misstatements resulting from these weaknesses.

In addition to the material weaknesses discussed above, we identified one reportable condition which, although not a material weakness, represents a significant deficiency in the design or operation of internal controls that could adversely affect IRS's ability to meet the internal control objectives described in this report. This condition concerns deficiencies in controls over hard-copy tax receipts and taxpayer data that increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data. In previous audits, we also reported that IRS was unable to determine the specific amount of revenue it actually collected for three of the federal government's four largest trust funds.[6] During fiscal year 2001, this condition continued to exist, but we have included it as part of the material weakness in financial reporting.

We have reported on these material weaknesses and reportable conditions in prior audits and have provided IRS numerous recommendations to address these issues, of which over 70 were still open as of the date of this report. We will follow up in future audits to monitor IRS's progress in implementing these recommendations. For more details on these issues, see appendix I.

## Compliance with Laws and Regulations and FFMIA Requirements

Our tests of compliance with selected provisions of laws and regulations disclosed one instance of noncompliance with laws and regulations that is reportable under U.S. generally accepted government auditing standards. This relates to IRS's timing of the release of tax liens on taxpayers' property. Also, IRS's financial management systems did not substantially comply with the following requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA): (1) Federal Financial Management Systems Requirements, (2) applicable federal accounting standards (U.S. generally accepted accounting principles), and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. IRS has readily acknowledged its financial management systems do not comply with FFMIA and the need to overhaul these systems as part of its broader systems modernization efforts.

[6] U.S. General Accounting Office, *Financial Audit: IRS' Fiscal Year 2000 Financial Statements*, GAO-01-394 (Washington, D.C.: March 1, 2001).

In prior years,[7] we reported that IRS was not in compliance with Section 6159 of the Internal Revenue Code, which authorizes IRS to enter into installment agreements with taxpayers to fully satisfy the taxpayer's liability. We did not identify any instances of material noncompliance with this statute during fiscal year 2001.[8]

For more details on these issues, see appendix I.

Except as noted above, our tests for compliance with laws and regulations disclosed no other instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

## Consistency of Other Information

IRS's Management Discussion and Analysis, required supplemental information, and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with IRS officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance. Under OMB guidance for the financial statements of federal agencies, agencies are asked to strive to develop and report objective measures that, to the extent possible, provide information about the cost-effectiveness of their programs. However, we found that IRS cannot report reliable cost-based performance measures relating to its various programs in accordance with the Government Performance and Results Act of 1993.

[7] GAO-01-394.

[8] Based on the results of testing for a statistical sample of 59 installment agreements IRS entered into with taxpayers during fiscal year 2001, we are 95 percent confident that the rate of occurrence of installment agreements entered into during fiscal year 2001 whose terms do not require full satisfaction of the tax liability did not exceed 5 percent.

## Objectives, Scope, and Methodology

Management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of 31 U.S.C. 3512, (c), (d), FIA are met, (3) ensuring that IRS's financial management systems substantially comply with the requirements of FFMIA, and (4) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and (2) management maintained effective internal controls, the objectives of which are the following:

- Financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, and disposition.
- Compliance with laws and regulations—transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and government wide policies identified by OMB audit guidance.

We are also responsible for (1) testing whether IRS's financial management systems substantially comply with the three FFMIA requirements, (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in these annual financial statements. For more details on our methodology, see appendix II.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting and compliance with laws and regulations.

We did not test compliance with all laws and regulations applicable to IRS. We limited our tests of compliance to those laws and regulations that had a direct and material effect on the financial statements or that were required to be tested by OMB audit guidance that we deemed applicable to the financial statements for the fiscal year ended September 30, 2001. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

## Agency Comments and Our Evaluation

In responding to this report, IRS noted that maintaining the unqualified audit opinion for its annual financial statements for the second year in a row is a significant accomplishment, and agreed with the report that this was the result of a strong commitment and hard work by its management and staff. IRS reiterated this commitment, emphasizing its belief that it is essential for a tax agency responsible for collecting over $2 trillion in tax revenue to be able to properly reflect its financial condition. IRS noted that its commitment is demonstrated not only by the unqualified audit opinion, but also by many improvements and initiatives it has undertaken, which are intended to address the issues we have reported and to improve the timeliness and accuracy of its financial information. For example, IRS cited improvements and planned initiatives to address problems such as controls over P&E disposals, review and accounting for open obligations, utilization of existing cost information, computer security, fingerprinting of staff entering on duty, and recording and reporting financial transactions. We will evaluate the effectiveness of these efforts in future audits.

In its response, IRS noted that the vast majority of the report is on the mark, but it was concerned that a few of the report's conclusions overstate its shortcomings. In commenting on the report's discussion of IRS's controls over budgetary activity, IRS agreed with the report's findings. However, IRS disagreed with the report's statement that IRS cannot ensure that its obligations do not exceed its budget authority. IRS indicated that it clearly does have this capability, as demonstrated by the fact that, according to IRS, its obligations have never exceeded its budget authority. However, the weaknesses we identified in IRS's controls over its budgetary activity, particularly with respect to delays in recording obligations, increase the risk that IRS could incur obligations in excess of its budget authority and not timely detect this occurrence. Our intent is to point out a potential impact of the internal control weakness we identified.

Regarding the timeliness of IRS's financial statement preparation, IRS disagreed with the report's statement that its efforts to produce financial statements extended nearly 4 months beyond the end of the fiscal year. IRS stated that on December 14, 2001, it delivered financial statements that contained reliable year-end balances. However, these financial statements were materially incomplete and thus did not conform to federal reporting standards. For example, (1) the balance sheet did not include taxes receivable or the related liability to Treasury, which constituted over 79 percent of IRS's assets and 85 percent of its liabilities, respectively, (2) two of IRS's footnotes excluded required material disclosures related to the status of its fund balance and its capital lease assets, and (3) material balances were missing from two other footnotes, as well as from the other accompanying information to the financial statements. The first materially complete draft financial statements were delivered to us on February 8, 2002. Additionally, auditable evidence supporting several material balances in the financial statements was not provided to us until several weeks after the December 14 draft of the financial statements was delivered. For example, support for IRS's $36 billion in tax refund rebates was not provided to us until January 2002.

In responding to our discussion of IRS's lack of a cost accounting system, IRS agreed that it needs an integrated cost accounting system, but believed that we overstated the impact of not having such a system on decision-making. IRS indicated that its current systems provide adequate cost information for good decision-making and that this information is being effectively used as part of IRS's strategic planning and budgeting process. In our report, we acknowledge that IRS has stated that its records contained the information it believes was necessary to determine the cost of various activities. However, our point is that the time and difficulty involved in obtaining this information from a variety of information systems significantly affects its timeliness and usefulness to managers as an ongoing decision-making tool. In addition, the problems we discuss in our report regarding the quality of IRS financial data at interim periods also affect the reliability of cost data.

Regarding the report's discussion of tax revenue and refunds, IRS noted that the report does not take into account the necessity of an interview with the taxpayer in many cases to determine EITC eligibility. We recognized in the report that there are inherent limitations to IRS's ability to identify and pursue the correct amount of taxes owed and to ensure that only valid refunds are issued. While not specifically cited in the report, we would agree that this is another relevant limitation. Nonetheless, given the

potential magnitude of improper refund disbursements and underreported taxes as discussed in this report, it continues to be our position that the preventive and detective controls IRS does have could be strengthened.

With respect to the report's discussion of manual tax receipts and taxpayer information, IRS disagreed with our statement that 128 of the over 20,000 individuals hired in fiscal year 2001 began working at IRS facilities before IRS received and evaluated the results of their fingerprint checks. IRS stated that based on its analysis, 52 such individuals began working without fingerprint checks. Subsequent to providing IRS a draft of our report that cited the 128 exceptions, IRS provided us with additional documentation. This documentation enabled us to clear 24 of these cases, thus reducing the number of exceptions to 104. We have changed our report accordingly. The difference between our current 104 exceptions and IRS's 52 exceptions is caused by several different categories of cases that IRS believes do not constitute exceptions with which we disagree. For example, in 13 cases, IRS cited that the employees were hired under a waiver that allowed them to enter on duty before their fingerprint check results were received. The waiver cited management's expectation that all fingerprint checks would be received for these employees by the end of their 2-week training period. However, for these 13 employees, no fingerprint checks had been initiated or received for at least 2 months after they entered on duty. In several of these cases, fingerprint checks had not been initiated at all at the time of our inquiry, even though some of these employees had already been on duty for over 7 months. We do not dispute that management has the authority to grant waivers in certain emergency situations; but as the waivers themselves indicate, this does not absolve IRS of its responsibility to perform due diligence to ensure that fingerprint checks are performed for such employees as soon as possible. As noted in the report, IRS has shown significant improvement in meeting its policy of ensuring that no individual enters on duty at any IRS location until the fingerprint results and case disposition information is received and reviewed.

The complete text of IRS's response is included in appendix III.

David M. Walker
Comptroller General
of the United States

February 8, 2002

Department of the Treasury
Internal Revenue Service

# MANAGEMENT DISCUSSION AND ANALYSIS

Fiscal Year 2001

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

## Mission Statement

*Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.*

### 1. Modernizing The IRS - Goals, Principles, and Change

Serving taxpayers better is the key concept behind everything the IRS is doing to modernize. The importance of service is reflected in three goals:

- Service to each taxpayer
- Service to all taxpayers
- Productivity through a quality work environment

Five guiding principles lead us to modernization. These guiding principles allow the IRS to manage both the organizational change and the operations and maintenance that must continue during the rebuilding process. The guiding principles are:

- Understand and solve problems from taxpayer's point of view
- Expect managers to be accountable—knowledge, responsibility, authority, action
- Align measures of performance to all organizational levels
- Foster open, honest communication
- Insist on total integrity

Finally, there are five equally important, critical areas of change needed for our modernization to be successful.

- Revamped business practices
- Customer focused operating divisions
- Management roles with clear responsibility
- Balanced measurement of performance
- New technology

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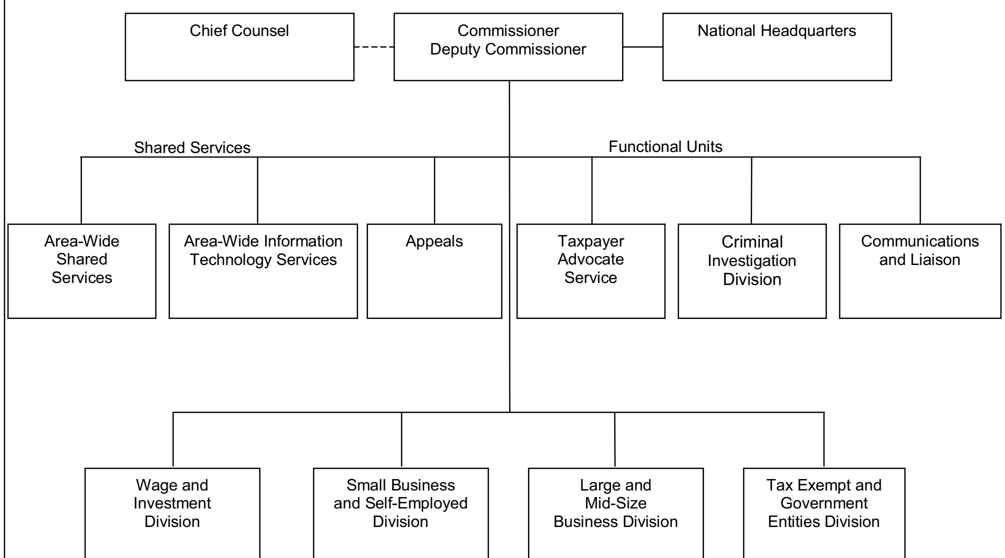
**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

## 2. Organization and Management

Our organization, as depicted below, is focused on taxpayers aligned to one of four operating divisions – Wage and Investment, Small Business and Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities.




The *Wage and Investment Division* is structured to serve taxpayers with less complex issues through a field organization that provides the information, support, and assistance that they need to understand and fulfill their tax obligations. Processing, account management, and compliance services are provided through eight Service Centers.

The *Small Business and Self-Employed Division*, has a compliance field organization that includes both examination and collection groups and reports to a multi-functional manager.

The *Large and Mid-Size Business Division* is predominantly a field organization that is structured into five industry groups which are; Communications, Technology & Media, Financial Services, Heavy Manufacturing & Transportation, Natural Resources & Construction, and Retailers, Food, Pharmaceuticals & Healthcare.

The *Tax Exempt and Government Entities Division* has a support structure for each type of taxpayer it will serve – exempt organization, pension plans, and governmental entities.

The *Appeals* organization remains an independent channel for taxpayers who have a dispute over a recommended enforcement action.

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The *Chief Counsel* has established a senior legal executive as the Division Counsel for each operating division to participate fully in the plans and activities of the operating division management and to provide high-quality legal advice and representation.

*Communications and Liaison* manages relationships with the media, Congress, state and local governments, and other external stakeholders.

The *Criminal Investigation* unit has sole responsibility for investigating criminal violations of tax law and will, for the first time, operate as a line unit within the IRS**.**

The centralization of Information Technology Services under the *Chief Information Officer* and of other common services under an *Area-Wide Shared Services* organization provides for efficient and standardized common services.

The *National Headquarters* focuses on strategic direction, capital allocations, and building partnerships with key stakeholders (e.g., Congress, Office of Management and Budget).

The *Taxpayer Advocate Service* is geographically distributed to provide local contact with taxpayers. Operating Division Taxpayer Advocates work directly with operating divisions to identify and recommend solutions to systemic problems.

The reduction in layers of management and the number of separate major units frees up personnel resources to increase support for customer education and assistance programs. Similarly, the reduction of separate operational units and the centralization of management of key functions such as processing, customer assistance, and collection within each division eases standardization of business practices and introduction of new technology.

### 3. FY 2001 Accomplishments

#### Background

The IRS Restructuring and Reform Act of 1998 (RRA 98) gave IRS a clear mandate – do a better job meeting the needs of taxpayers as well as collecting the money. We expressed this direction in a new IRS mission statement: “Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.”

It is equally important that we define the specific goals and objectives needed to achieve our mission. They are top-quality service to each taxpayer in every interaction; top-quality service to all taxpayers through fair and uniform application of the law; and productivity through a quality work environment. If progress is made on all three of these goals, we can be confident that we are moving toward achieving our mission and meeting the public’s expectations.

Commencing in FY 2001, the IRS Commissioner determined that a set of critical measures comprised of taxpayer facing activities would represent the IRS strategically, until the planned strategic measures were implemented. These measures, totaling 65 were carefully selected and adopted by the senior management team and are used for all external and internal reporting. The 15 key performance indicators outlined in the original FY 2001 budget were

replaced with the critical measures and published in the FY 2002 Congressional Justification issued in April 2001.

In development of both the IRS budget and the strategy and program plans, each division commissioner also identified a set of measures along with targets that represent their strategies and program areas funded. At the operational level, each Commissioner is responsible for reporting on delivery of performance and budget through the Business Performance Review System. This system of reporting provides for scheduled meetings of the IRS Senior Management team led by a division commissioner to discuss accomplishments, performance against plan, and budget impacts.

To provide continuity across the Service that allows the Commissioner to manage the IRS at the strategic level, organizational units are required to articulate their strategy and program plans in terms of customer service and the functional activities that deliver customer service and compliance. Those services and the critical measures fall into three distinct categories:

*Pre-Filing Services* – services that are provided to a taxpayer before the return is filed to assist in filing a correct return.
*Filing Services* – services that are provided to a taxpayer in the process of filing a return and paying taxes
*Post-Filing Compliance Services* – services that are provided to a taxpayer after a return is filed to identify and correct a possible erroneous underpayment.

Activities associated with Administration of Earned Income Tax Credit (EITC) are threaded throughout the three categories listed above and also discussed in greater detail in the Management Challenges section of this document.

Performance measures also address *Customer Satisfaction* in all of the operating divisions and the service-wide level of *Employee Satisfaction.*

By organizing the strategy and program plans, the budget, financial plans and reports, and accounting systems around the three service categories and supporting activities the IRS ensures a consistent and holistic approach to planning for and delivering on our strategic goals and objectives.

**Pre-Filing Services**

Better pre-filing services can reduce the need to fix a problem after it has occurred, or to take enforcement actions. Both are more time consuming and costly for the taxpayer and the IRS. This approach promises to be particularly helpful for America's small businesses, especially start-up businesses, which are confronted with a large array of new tax and filing requirements. If we can eliminate confusion, errors and mistakes before a return or form is ever filed, America's taxpayers will be spared countless numbers of notices and communications with the IRS. By helping taxpayers better understand their tax filing, payment and reporting requirements, and by giving them the information and tools they need, we believe voluntary compliance should increase markedly.

The Stakeholder Partnership, Education and Communications (SPEC) branch of our Wage and Investment Operating Division worked in FY 2001 to energize the VITA (Volunteer Income Tax

Assistance) return preparation program. Working with more than 18,000 volunteer sites across the country W&I assisted an estimated 4.7 million taxpayers wanting this service.

Working hand-in-hand with SPEC to help taxpayers understand their obligations, is the Taxpayer Education and Communications (TEC) function of the Small Business/Self Employed Operating Division. Once fully realized, both their education and pre-filling services will benefit both taxpayers and our tax administration system in many ways. For example, in FY 2001, 1,181 small business taxpayers benefited from IRS workshops while 3,104 taxpaying entities were provided with assistance via issuance of voluntary agreements and industry guides.

In FY 2001 IRS continued to provide electronic communication tools for taxpayers, answering more than 264,000 questions submitted by taxpayers in all tax related filing categories.

**Filing Services**

A primary indicator of success can be measured by the filing season. IRS delivered a successful filing season in 2001. Total revenue collected was $2.1 trillion. We processed over 130 million individual returns, and issued over 92 million refunds. IRS representatives also met with 9.4 million taxpayers and we answered 108 million telephone calls and responded to 19.2 million letters. The sheer size of the numbers is just one indicator of the complexity and magnitude of our task.

Since 1998, we provided extended hours of telephone service during the filing season. We also put on more assistors at peak hours, rather than just during normal business hours. Almost 108 million taxpayers called on one of our toll-free lines during FY 2001. We answered 76 million automated and Teletax calls, and our live assistors answered 32 million taxpayer calls. Additionally, our San Patricio, Puerto Rico call site became fully operational in 2001 and we believe that it will greatly assist us in providing better access and service to Spanish-speaking taxpayers.

In 2001, more than 40 million taxpayers filed electronically – a 13 percent rise from last year. Since 1997, *e*-filing increased by 110 percent, and on-line filing grew by a staggering 1,700 percent. Achieving the congressionally mandated goal for electronic filing (80 percent of returns filed by 2007) will be very difficult, but by working with taxpayers and practitioners, we will continue to remove the barriers to *e*-filing.

For the 2001 filing season, we added 23 additional forms to the 1040-*e*-file program. And we will achieve a major milestone in 2002 – virtually all 1040 forms and schedules can be filed electronically and no paper signature document is required. We also introduced Electronic Federal Tax Payment System (EFTPS) OnLine, which allows businesses to enroll in the system, make secure federal tax payments and check their electronic payment history over the Internet.

Taxpayer use of the IRS web site in FY 2001 smashed all records – 2.6 billion hits with more than 103 million forms and publications downloaded. In 2001, we also launched the Small Business and Self-Employed Community web page. And in 2002, we will unveil a revamped IRS web site designed to be a world-class transaction based gateway.
Many taxpayers prefer telephoning the IRS. Today, nearly all callers have almost immediate access to automated services. However, in the 2001 filing season, taxpayers that wanted to

reach an assistor were successful only 64 percent of the time. Although this was an improvement, these times are still unacceptable to both taxpayers and the IRS. Our real goal is to improve the quality of the service we provide taxpayers both on the telephone and at our taxpayer assistance centers.

Once connected, taxpayers must get prompt, accurate and courteous answers to their account and tax questions. Here too, we have made substantial progress towards providing better service to taxpayers. The telephone quality rates for tax law and tax account questions showed a marked improvement in FY 2001. They were up to 75 percent and 69 percent respectively as compared to 73 percent and 60 percent over the same period last year. Although we would agree with the GAO's assessment that we have not yet attained a world class customer service level, we believe that we are on the right track to achieving that goal.

Throughout the year, and at a variety of locations, we also schedule the highly acclaimed Problem Solving Days to resolve long-standing taxpayer issues for those who cannot take advantage of weekday problem solving services. Problem Solving Days have an excellent track record and we are moving toward incorporating the concept into daily operations. That means using a cross-functional approach to resolve most tax account issues with a single visit or phone call at any time throughout the year. To help us meet this need; we created a new job at the IRS, "Tax Resolution Representative." These IRS employees received training and authority to provide "one-stop-service" for a broad range of issues ranging from answering tax questions to resolving payment problems.

In 2001, we provided even more tax burden relief to small businesses, raising the deposit threshold yet again from $1,000 to less than $2,499 in quarterly employment taxes. This affected about one million small businesses. Through our continued efforts, we estimate that between 70-80 percent of them can be relieved of the burden of making as many as 12 deposits annually, the most frequent transaction of small businesses with the IRS.

### Post-Filing Compliance Services

Our goal in 2001 was to stop the long-term decline in our compliance activities while beginning to focus it effectively and efficiently on key areas of non-compliance. Our tax system depends on each person who is voluntarily meeting their tax obligation having confidence that their neighbor or competitor is also complying. Service to all taxpayers means applying the tax law fairly and uniformly. Therefore, when taxpayers do not voluntarily meet their tax obligations, the IRS must use its enforcement powers to collect the taxes that are due.

However, we simply do not have the resources to attack every case of non-compliance. We must apply our resources to where non-compliance is greatest while still maintaining adequate coverage of all other areas. Our near term goal in 2001 was to stabilize the level of our key compliance activities while beginning to focus on the areas of greatest risk to our nation's tax system.

After careful study we identified and are addressing four important areas of systematic non-compliance. These areas are: misuse of devices such as trusts and passthroughs to hide income, use of complex and abusive corporate tax shelters to reduce taxes improperly, failure to file and pay large accumulations of employment taxes, and erroneous refund claims.

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One of the most powerful tools that we use to ensure compliance is matching information received from employers, financial institutions and other businesses with information reported by taxpayers. In fact, third parties report approximately 80 percent of the personal income received by taxpayers. An important compliance strategy is to use this data as effectively as possible.

For example, in FY 2001 IRS began capturing data from 16.8 million K-1 forms which are used to report income, credits and deductions of partners, shareholders or beneficiaries. In 2002, the IRS will change its processing procedures and begin processing and matching K-1s reporting almost $700 million of income and also, importantly, reported losses on trusts and passthroughs. This will help us to find potential problem cases and to follow up, when necessary, with audits.

However, no matter how effectively we use our resources and new techniques to identify and prevent problems, some cases require intervention by IRS compliance personnel. For example, although 80 percent of the individual income is reported by third parties, the remaining 20 percent, mainly business income, are not reported and often require in-person auditing to verify. Also, business income, including that by passthrough corporations, partnerships and trusts can only be verified through auditing.

In FY 2001, we implemented the first phase of a multi-year Collection Re-engineering Program. It modifies our Inventory Delivery System to ensure that we promptly assign business tax cases to Revenue Officers. The Electronic Fraud Detection System is also being enhanced to include selected Business Master File data that will permit research, analysis, and evaluation of fraud detection scenarios for business returns. Traditional Collection activities, while not meeting the goals, have begun to stabilize and the number of liens filed and levies issued increased by 49 percent and 103 percent respectively over the previous year. We also made ten percent more determinations for innocent spouse cases and processed 40 percent more offers in compromise.

In-person examinations of individuals and corporations are the area that takes the longest to turn around because of the length of time it takes to train people and to complete cases even after they are initiated. We have started to see some progress with an increase of 27 percent in examination of large corporations. We still have far to go in our in-person examination rate, which declined about 20 percent. In FY 2002, new revenue agent hires, increased efficiencies gained from handling taxpayer cases and more direct case time will increase the number of field examination and correspondence cases closed. If we stay this course, we believe that compliance activity levels will increase over the next three years.

In FY 2001, the IRS conducted an assessment of their external and internal environments to identify trends, issues, and problems affecting business operations and service delivery. Using that as a basis, the IRS developed major strategies to provide guidance to management in achievement of strategic goals over the next two to three years. Within each strategy are more specific operational priorities and improvement projects. Major parts of many IRS strategies are accomplished through partnerships with state governments, practitioners, and other industry and local groups who are regularly in contact with taxpayers.

Two of the strategies developed, Address Areas of Non-Compliance and Stabilizing Traditional Compliance Activities, address initiatives focusing on collection of tax debt. These strategies identify more specific operational priorities and improvement projects for key compliance areas

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within the organization. The priorities and projects provide practical guidance about how the limited IRS resources are allocated and where management focus should be placed in order to achieve the IRS goals.

- Address Areas of Non-Compliance

Lack of reliable measures of compliance limit the IRS' ability to assess progress on its goal of serving all taxpayers through effective and fair application of the tax laws. However, research indicates that there are major problem areas of substantial noncompliance. Research studies have also provided vital information for guiding future pre-filing efforts, identifying issues promptly, providing guidance to field examination teams, and shaping communications and information exchanges.

As mentioned previously, IRS began a matching program of information returns to uncover the estimated 20% of pass-through income not reported. This program will match 100% of Forms K-1 income reported to Forms 1120S, *U.S. Small Business Corporation Income Tax Return;* 1065, *U.S. Partnership Return of Income;* and 1041, *U.S. Fiduciary Income Tax Return (for Estates and Trusts)*.

Through commitments from the Department of Justice (DOJ) Tax Division and its own Criminal Investigation Division, the IRS established an Abusive Trust Compliance Strategy to increase the examination time applied to Partnership and Fiduciary return areas with abusive tax shelters. Combined Examination and Collection specialty groups were formed for this purpose and were further supported by specialists to uncover areas of fraud.

In the area of Unpaid Trust Fund Taxes, the IRS, along with the DOJ, established a Trust Fund Compliance Initiative to test new procedures to reduce recurrence among in-business trust fund taxpayers. Re-engineered procedures include pursuit of civil injunction rather than criminal prosecution, and modifications to the Inventory Delivery System, which the IRS uses to facilitate prompt assignment of current trust fund accounts.

The IRS Criminal Investigation Division provided the Administration and Congress with information regarding the scope of money-laundering activities, both in the U.S. and worldwide. This information has been an important factor in the promulgation of more effective money-laundering legislation. More importantly, these efforts are expected to have a profound effect on overall tax compliance because they have laid the groundwork for making the transfer of money in or out of the U.S. a money-laundering predicate (specified unlawful activities) offense.

Fraud Detection Centers, located on service center campuses and staffed by Criminal Investigation employees, implemented new processes to enhance the detection of questionable refund returns. In addition, a questionable Refund Scoring formula has been developed to improve identification of false refund claims. Expansion of the program is planned to include business refund fraud with initial focus on employment tax return and trust fund fraud.

- Stabilize Traditional Compliance Activities

Regardless of how successful the IRS is in preventing taxpayer errors, it will always be necessary to intervene through examination and collection actions, and investigations when non-compliance or non-payment is found or suspected to be occurring.

Levels of traditional examination and collection activity have continued to decline drastically over the past several years because of reduced staffing, new requirements imposed by the IRS Restructuring and Reform Act of 1998, the uncertainty over some provisions of the act, and the need to divert considerable numbers of staff to assist taxpayers during the filing season. Risk-based compliance intervention techniques, coupled with more focused and rapid intervention, will improve the quality and speed of casework.

In an effort to concentrate on getting back to core compliance processes (examining tax returns and collecting taxes), the IRS reduced filing-season support by compliance personnel by almost 50% from past years' levels. New initiatives to re-engineer the collection and examination functions were undertaken to change the way both revenue agents and officers do their jobs.

Centralization of Innocent Spouse and Offer In Compromise cases also occurred in FY 2001 to establish control of escalating inventories in both areas and to reduce the burden on field employees.

In response to the dramatic change in workload, the Appeals Division continued a comprehensive training program for its newly hired settlement officers about collection issues, to equip personnel with the knowledge and skills to handle the new Collection Due Process and other collection type issues. To reduce the length of the appeals process, improve service to all its customers while spending limited compliance time most productively, Appeals implemented a major strategy for issue management to identify issues that represent non-compliance with the tax laws that are deemed important and widely agreed upon. In addition, Appeals, in partnership with the operating divisions, developed a common position about issues to assist taxpayers in areas more prone to examination. Implementation of a fast-track mediation/settlement program was completed to save time for taxpayers in the large and mid-sized business areas, to resolve issues quicker and to save time during the appeals process for both the IRS and the taxpayer.

The IRS' strategies continuing into FY 2002 address the need to stabilize the traditional compliance activities in the near term, and design future strategies around new capabilities of business systems modernization for more fundamental improvements.

To further improve productivity in FY 2002, the IRS plans to complete hiring of traditional enforcement personnel for collection and examination. In addition, continued improvements in areas such as reducing taxpayer burden and broadening the use of electronic interactions with taxpayers are expected to contribute to improvements in many IRS performance areas.

**Customer Satisfaction**

The IRS partners with Treasury by establishing strategies to maximize voluntary tax law compliance by emphasizing customer satisfaction at each phase of the filing process.
While the effects of the IRS reorganization on the taxpaying public will not be known for several years, public perception of the IRS has been steadily rising over the last three years. In FY

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2001, the IRS received a 46% favorability rating versus the extraordinary low level of confidence (32%) expressed by the public during the 1997/1998 timeframe.

Coupled with improvements in customer satisfaction, scores in transactional surveys at the operational levels gives an indication that the improvements the IRS is making organizationally appear to have had an impact on customer satisfaction. In FY 2001 improvements were made in the following categories Automated Collection (increase from 3.41 to 3.46 on a four-point scale); Collection Field (increase from 4.45 to 5.01 on a seven-point scale); Correspondence Examination (increase from 4.04 to 4.18 on a seven-point scale); and Field Examination (increase from 4.41 to 4.65 on a seven-point scale). Another indicator of improved customer satisfaction in the IRS can be seen in rising quality scores since quality factors are often the same factors addressed in the transactional surveys. Scores have shown improvement in widely publicized taxpayer assistance areas such as Tax Law (increase from 73 to 75 percent) and Account Inquiries (increase from 60 to 69 percent), and the traditional compliance functions such as Field Examination (increase from 58 to 70 percent), Correspondence Examination (increase from 70 to 71 percent), and Automated Underreporter (increase from 93 to 95 percent).

Some of the drivers that have led to improved customer satisfaction and quality ratings for FY 2001 include:

- Continuous improvement in the way processes work and the way cases are assigned;
- Updating tools and technology for employees that allow them to better answer questions and address concerns of the taxpayer;
- Improving Earned Income Tax Credit outreach activities, including increasing the toll-free assistance and extensive marketing and taxpayer information campaigns;
- Conducting paid advertisement to promote electronic filing and established partnerships with industry members by providing hyperlinks to partner websites;
- Expanding the electronic filing options by adding an additional 23 forms and schedules taxpayers can file electronically; and
- Offering expanded electronic payment options, including pay-by-phone (toll-free) and pay-by-Internet applications.

In FY 2002, the IRS will begin to consider customer satisfaction in the context of pre-filing, and filing activities. Previously, our outlook largely considered results from transactional surveys that viewed customer satisfaction from the post-filing side. While this information is useful, it cannot help the agency identify improvement opportunities until a problem occurs after a return is filed. By widening our vision of customer satisfaction, the agency will be able to identify customer's concerns across the entire filing experience and create solutions that prevent, rather than solve, problems. For example, the Wage and Investment operating division will use market segment surveys to better understand the pre-filing and filing experience from their customers' perspective. This data will be critical in identifying their customers' behavior patterns, failpoints, needs, and preferences.

The IRS will also seek the opinions of its partners through the Stakeholder Partnership Education and Communications (SPEC) survey in FY 2002. Data from this survey will help refine our understanding of the broad categories of experiences that exist with the IRS' partners. Most importantly, the survey will clarify our partners' definition of quality and their specific service expectations. This kind of data is consistent with the agency's shift to customer-focus and an emphasis on the entire spectrum of filing activities (pre-filing, filing, and post-filing).

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The *Small Business and Self-Employed* operating division will also use customer satisfaction studies as one aspect in evaluating the effectiveness of an innovative program aimed at newly created small businesses --- the Mentor and Monitor Program. Focus group interviews will assess the small business taxpayers' experiences with each aspect of the pre-filing and filing activities of the new businesses. In this case, a qualitative research study will reflect the customer's expectations and point of view, a vital consideration for the evaluation of this novel education and service delivery program.

The proactive approach to customer satisfaction measurement can also be seen in the *Large and Mid-Size Business* (LMSB) surveys of the audit process. These surveys will assess customer satisfaction at the audit planning and audit completion processes. In addition, these surveys will provide data that support improvement initiatives and track the success of those improvement opportunities. As with the previously mentioned studies, the agency anticipates that the creation of improvement initiatives will be an important consequence of these LMSB customer satisfaction surveys.

Last year, the concept of service to taxpayers went far beyond what is normally expected of the IRS. Two events – the issuance of millions of advance refund checks and our response to the tragic events of September 11 – demonstrated how we could provide service to taxpayers under extraordinary circumstances.

- *Advanced Refund Initiative*

Just six weeks after President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001, we delivered for taxpayers by getting their checks in the mail. To put in place the approximately $36 billion advance payment provision, we began work weeks earlier so that we would be prepared to handle the first rebate in a quarter century.

The IRS coordinated an unprecedented outreach to America's taxpayers, an intricate computer programming project, a flurry of news releases, an updated *irs.gov* web site and additional assistors to handle record call volumes.

Over Memorial Day weekend, Congress gave final approval to the 2001 tax bill, which included the advance payment. The provision set a maximum amount of $300 for an individual, $500 for head of household or $600 for married couples filing jointly.

The checks were an advance of a 2001 rate reduction credit and were subject, as most tax provisions are, to various exceptions and limitations. The five- percent credit was in lieu of a lower tax bracket – to 10 percent from 15 percent – effective 2002.

The Department of Treasury estimated it would issue 90 million checks, worth approximately $36 billion, over a 10-week period. The checks began arriving in mailboxes on July 23 and no checks were issued after December 31, 2001.

We decided to issue notices to all taxpayers, both those who qualified and those who did not. We hoped the notices, issued prior to the checks, would answer taxpayers' questions and reduce the number of telephone calls. We contracted with a private vendor to print notices for 130 million people – nearly half the population of the United States.

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This is not to say the process was problem-free. In July, a computer glitch caused almost a half-million taxpayers to receive notices with inaccurate amounts of their checks. However, the error was identified and those taxpayers were sent a second notice with the corrected amount. In addition, our telephone systems were overwhelmed and many taxpayers could not at first get through to us. Here too, the IRS responded by retaining our seasonal workers and applying additional resources to address the crunch. All told, we answered 23.5 million taxpayer calls on the advanced refund both by our Customer Service Representatives and through automated telephone applications.

- *IRS Response to the September 11, 2001 Terrorist Activity*

Following the September 11 national tragedy, IRS and Treasury Department employees did their best to minimize the distraction of tax issues for the victims. By September 14, three days after the attack, we provided administrative relief to the victims in the form of extensions to file returns and pay taxes. We also suspended for six months many enforcement actions for the affected taxpayers. In addition, we established special toll-free numbers to answer any questions, and we set up a special disaster relief page on our web site.

To complement these efforts, we published a brochure; “Help from the Internal Revenue Service for Those Affected by the Terrorist Attacks on America” that explains the tax relief we are providing. To reach the largest possible audience, we also placed public service advertisements in *USA Today, Sports Illustrated* and *Business Week*. However, our efforts do not end there.

Our Large and Mid-Size Business Division (LMSB) worked closely with airline industries on the Air Transportation Safety and System Stabilization Act legislation. It allowed for extension of due dates for deposits and clarification that federal loans are included in the airlines’ income. LMSB also held an intensive, two-day technical meeting to discuss issues with the principal industries located in the World Trade Center.

On the law enforcement side, we are providing expertise on money laundering. We are a key part of Operation Green Quest, the new multi-agency initiative targeting funding sources for terrorist organizations.

Before and after the terrorist attacks, the IRS’ Tax Exempt/ Government Entities (TE/GE) Operating Division also helped educate the public on the legal requirements organizations must meet to qualify for tax-exempt charitable status.

On September 18, we placed a new, easy-to-understand publication on our web site that provided information to assist the public to make use of charitable organizations. We also announced that we would speed processing of requests for tax-exempt status from new charities formed to assist the victims. Although we expedited the process, we did not lower our standards for new organizations applying for the tax-exempt status.

In addition, we worked with the September 11 charities to get donations to the victims’ families. On November 16, we issued interim guidance that recognized the unique circumstances caused by the tragedy. The notice stated that the charities will not put their exemptions at risk by making payments to the victims and their families without first proving they are in financial need. We wanted to send a clear message that charitable groups that act in a reasonable and good-faith manner to help the victims would not endanger their tax-exempt status.

**Employee Satisfaction**

In FY 2001, the IRS conducted two surveys of employees. SURVEY2001 was a census survey of all employees, with the items focusing upon issues that were deemed “actionable” at the workgroup level. Approximately 79,000, or 68%, of employees responded to the survey. It was administered from April through May 2001 and approximately 10,000 Workgroup Reports were produced in July 2001. Workgroups used the survey results to hold Employee Satisfaction meetings, identify workplace issues, and take steps to resolve them.

To complement the census survey, a Climate Survey was administered in August 2001 to a random sample of employees. About 14,700 surveys were provided, and slightly more than 7,500 employees responded (approximately 51%). The Climate Survey primarily focused upon items deemed actionable at the Corporate-level.

Employee Satisfaction remains one of the key drivers in the Balanced Measures Program that the IRS developed beginning in 1998. The ability to retain and develop talented personnel is a determining factor in how well we provide the quality of service taxpayers expect.

The overall level of employee satisfaction for FY 2001 was 51%, as measured by SURVEY2001. The survey results fell below both the 60% target and the FY 2000 level. The decline from 59% in FY 2000, to 51% in FY 2001, can be attributed to the effects of the reorganization (which is consistent with the Climate Survey). The IRS Commissioner has made improving employee satisfaction the responsibility of each individual manager (currently a commitment in each manager’s performance plan) and every Operating, Functional, and Support Division (OD, FD, and SDs). The individual workgroup meetings are taking place now, and the results will be seen when the FY 2002 survey is administered, beginning in April 2002.

For FY 2001, the IRS included in its major strategies one that focused on Recruitment, Development, and Retention of a Qualified Workforce. To accomplish this strategy, in FY 2001, the IRS implemented the following actions:

- Improved management training classes to enhance skills by re-designing our management and leadership curriculum, and equipping managers with more of the tools needed to do their jobs, such as workload and strategic management;
- Improved employee training by providing Customer Service Representatives with specialized training to help them better serve the taxpayers;
- Developed and delivered a state-of-the-art classroom and on-the-job training for compliance positions;
- Implemented the state-of-the-art Employee Resource Center to provide employees access to workplace information and services by Intranet, e-mail, telephone, and fax;
- Incorporated leadership competencies into performance evaluations for executives and managers to facilitate alignment of the evaluation system to the IRS’ strategic goals;
- Simplified employee research tools by realigning the Internal Revenue Manual (IRM) by business processes, and merging procedural memoranda and desk/user guides into existing IRMs;
- Established a Service-wide Internal Communication Planning Group to ensure that critical employee messages are communicated in the same manner throughout the organization; and
- Developed a “New for You in 2002” information campaign to target IRS employees and communicate changes for the upcoming filing season.

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In FY 2001, the Employee Satisfaction Survey was reduced in content and layout based on the advice of the new survey vendor. Many items were deleted or changed to minimize the burden on employees. For FY 2002, with our contract renewed with the survey vendor we plan to continue to improve the readability of the survey while increasing electronic (telephone and web-based) survey participation.

**4. Management Challenges and High-Risk Areas**

Over the last several years the General Accounting Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) have identified several Management Challenges and High-Risk Areas facing the IRS. While specific steps and actions to address these issues have been identified, progress toward addressing these issues is addressed through IRS' existing program activities. Measures of IRS program activities serve to show progress in addressing the management challenges and high-risk areas. The following chart is a crosswalk showing the relationship between the management challenge and the program activities.

| Management Challenge or High Risk Area | Program Activity | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Pre-Filing | Filing | Compliance | Research & SOI | Information Services | Information Services Improvement Projects | Business Systems Modernization | EITC | Shared Services | General Management & Administration |
| Financial Management | | | | | | | | | | X |
| Security of the IRS' Information Systems | | | | | X | | | | | |
| Taxpayer Protection and Rights | X | X | X | | | | | | | |
| Processing Returns & Implementing Tax Law Changes During Filing Season | X | X | | | | | | | | |
| Customer Service & Tax Compliance Initiatives | X | X | X | X | | | | | | |
| Providing Quality Customer Service Operations | X | X | X | X | | | | | | |
| Impact of Global Economy on Tax Administration | X | | X | | | | | | | |
| Modernization of the IRS- Organizational Restructuring | X | X | X | X | | | | | | X |
| Revenue Protection – Minimizing Tax Filing Fraud; Noncompliance with EITC | X | X | X | | | | | X | | |
| Implementation of the Government Performance & Results Act | | | | | | | | | | X |
| Modernization of the IRS-Technology Modernization | | | | | | | X | | | |
| Collect Unpaid Taxes | X | | X | | | | | | | |

***Table: Management Challenge Cross-walk to Program Activity***

The following pages summarize each Management Challenge and High-Risk area along with management actions completed in FY 2001. The issue descriptions provided for these management challenges were drawn directly from documents prepared by the TIGTA and GAO.

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## Financial Management

### Issue

The IRS' current financial systems alone can not produce reliable information necessary to prepare financial statements in accordance with federal accounting standards. The data produced from the current financial system has to be reconciled with other subsidiary systems to produce reliable financial statements. Further, the current systems do not comply with the requirements of the Federal Financial Management Improvement Act (FFMIA). In addition, the current financial systems can not provide reliable cost accounting information. While a balanced measurement system could provide information on the results of programs to improve customer service and increase compliance, the cost of achieving these results must also be known. Without reliable cost accounting information it is difficult to measure the effectiveness of various tax collection and enforcement activities and to judge whether resources are appropriately allocated among competing priorities. Reliable cost-benefit performance information related to collection and enforcement activities is also necessary to better assist Congress in making informed funding decisions concerning the appropriate levels and uses of resources.

### FY 2001 Accomplishments

A major initiative for FY 2001 was beginning the development of the Integrated Financial System (IFS). This system is designed to address material weaknesses in financial reporting and bring the IRS into compliance with the Federal Financial Management Improvement Act (FFMIA). The IFS will be deployed in two releases. Release 1 will contain the core financial functionality (i.e., General Ledger, A/R, A/P, Funds Management, Cost Accounting, and Financial Reporting) as well as budget formulation. Release 2 will provide for non-core systems (i.e., fixed assets, travel, procurement). The requirements phase of IFS was completed in October 2001, with the procurement of the software targeted for April 2002. Deployment of Release 1 is anticipated to be completed by October 2003 and Release 2 should be completed by April 2005.

## Security of the IRS Information Systems

### Issue

Although computer security has measurably improved, computer security control weaknesses continue to place automated systems and taxpayer data at serious risks to both internal and external threats. As the primary revenue collector for the United States, the IRS is a target for both terrorists and hackers. This threat has increased over the last few years with more interconnectivity of systems. Until stronger security controls are in place over its information systems, tax-processing operations remain vulnerable to disruption. Furthermore, the sensitive taxpayer data maintained by IRS is at risk of being disclosed to unauthorized individuals, modified and improperly used, or destroyed, thereby unnecessarily exposing taxpayers to financial crimes such as identity fraud.

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**FY 2001 Accomplishments**

The Service-Wide Security Office (formerly Security and Privacy Oversight) has implemented programs with the goal of managing security risks and the costs related to mitigating them, rather than just reacting to individual incidents and audit findings. New escalated threats realized in the recent terrorists incidents call for re-evaluation of strategy and tactics. Service-Wide Security consists of the following programs: Security Evaluation and Oversight, Cyber Security Operations, and Modernization Security. It also manages support to two executive-level security groups, the Technology Security Committee and the Subcommittee on Security of the Financial Management Controls Executive Steering Committee (FMCESC).

The Office of Security Evaluation and Oversight (SEO) conducted intensive, on-site reviews encompassing physical, personnel and logical security of all IRS critical assets to identify security weaknesses at the sites and worked with local and Headquarters staff and management to develop corrective action plans. In addition, SEO initiated improvements to computing center physical security targeted to Department of Justice Level V, and provided training in responding to chemical and biological threats at all ten campuses. The SEO also completed secure configuration standards for major IRS platforms, including Windows NT, Unix, and updated International Business Machines/Resource Access Control Facility (IBM/RACF) guidance. The SEO also worked with Information Technology Services (ITS) to mitigate serious weaknesses in the electronic filing system. The SEO was responsible for development and implementation of user-friendly improvements to the IDRS program that resulted in user-generated passwords and single sign-on capabilities.

The SEO worked with the Wage and Investment (W&I) Division to mitigate weaknesses in remittance processing operations nationwide and through the FMCESC Security Subcommittee provided leadership for establishing improved security standards at lock box operations.

The Office of Cyber Security Operations leveraged expertise available through contractors and internal resources to establish a 24/7 incident response capability. In addition, Cyber Security is developing situation management centers that will support centralized response to incidents and larger disruptions. In FY 2001 the Cyber Security Office initiated and continues to develop a centralized approach to security awareness activity, including a strong program of awareness about unauthorized access to taxpayer information (UNAX). Cyber Security Operations made improvements to the sensitive system certification process through an automated tool that reduces the burden of developing certification documentation by system owners. Additionally, the Office developed a security assessment framework, based on the CIO Council Information Technology Security Assessment Framework (ITSAF) and National Institute of Standards & Technology (NIST) guidance, which identifies security targets and metrics for achieving security objectives. The Treasury Department adopted this framework as a best practice for all its bureaus.

An Office of Modernization Security is in development to provide direct support to the Business Systems Modernization and PRIME Contractor organizations to ensure that security is adequately addressed in the Enterprise Architecture Life Cycle and each modernization project in FY 2002.

In the weeks following the September 11 terrorist attacks, we conducted a security assessment of all IRS facilities. Aided by security experts, we determined what immediate steps needed to be taken, such as screening and guard services. In addition, we will establish a consistent

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security standard for key areas such as screening employees, identification badges and parking access.

Given the enormous volume of mail that the IRS handles, we are concerned about hazardous materials threats. As recommended by the Centers for Disease Control, we arranged for all employees throughout the country who handle mail to have available masks and gloves that meet or exceed recommended standards. In addition, we are taking measures to limit employees' exposure to any hazardous substances and, in the event that a hazardous substance is suspected or identified, contain it in one place. We are committed to taking whatever actions are necessary to protect our employees' health and safety as well as the integrity of our tax administration system, especially during the 2002 filing season.

**Modernization of the IRS – Technology Modernization**

**Issue**

The ability to balance the goals of helping taxpayers meet their tax responsibility and improving overall compliance with tax laws depends on the successful completion of the modernization effort. Modernization of technology is crucial to implementing the new business vision of providing world-class service to taxpayers. While the development of new technology evolves, existing operations must continue, and improvements must be made to meet the needs of tax administration and demonstrate to taxpayers the IRS' commitment to improved service.

**FY 2001 Accomplishments**

IRS completed the IRS Enterprise Architecture 1.0, or Blueprint 2000, which gives the service the ability to ensure that modernized projects are coordinated across the entire IRS enterprise, producing an integrated and unified set of systems, scoped to eliminate duplication. IRS also put the first two business applications, Customer Communications FY 2001 (CC01) and Customer Relationship Management Exam (CRM Exam) into service and all related projects are making progress in their development lifecycle. In FY 2001 the Business System Modernization Office completed high-level strategies for tax administration (Tax Administration Vision and Strategy – TAVS) and internal management (Internal Management Vision and Strategy – IMVS), and approved the comprehensive Enterprise Architecture. As the modernization efforts continue, projects will all flow from one of three foundation strategic architecture components. During FY 2001, the IRS made significant progress in improving overall management of its modernization efforts by further refining the configuration and release management processes and establishing financial controls and portfolio management to better align funding and resources with its business priorities.

**Implementation of the Government Performance & Results Act (GPRA) of 1993**

**Issue**

The IRS Strategic Plan and Budget, which includes the Annual Performance Plan and Annual Performance Report, satisfies a major requirement of the Government Performance & Results Act (GPRA). It will take several years to achieve a fully acceptable set of balanced measures

that can be used at all levels of the organization. Balanced measures are being aligned with the employee performance evaluation system to clearly link the work of individual managers and employees to the mission and goals. Additionally, the effectiveness of compliance improvement initiatives and current compliance levels cannot be accurately determined until a measure of taxpayer's voluntary compliance is developed.

**FY 2001 Accomplishments**

Balanced measures, including those needed to address quality for many compliance areas, that were identified during the FY 2003 Strategic Planning Process continued to be developed in FY 2001. Balanced Measures were also developed at the strategic management level and reporting mechanisms for FY 2002 have been implemented. In addition, each of the divisions has begun the task of drilling down into their organization targets/goals for key performance measures. Beginning in FY 2002 Strategic measures will be used along with the critical measures to assess the IRS' overall performance in delivering its mission and strategic goals. Development of the strategic measures for voluntary compliance, burden, overall productivity, and overall customer satisfaction was completed in FY 2001. Consideration is also being given to development of an additional strategic measure to address the need to report on the portion of "Potentially Collectible Inventory" in the organization. Modernization of the current Executive Management Support System was completed to meet interim needs of the service in the area of balanced measures reporting. This new web-based system will also interface with the joint WI & SBSE data mart to automate data reporting for a majority of the critical and non-critical performance measures. In FY 2001 the service completed alignment of the IRS Performance Management System (Appraisals) with the IRS Mission and Strategic Goals for all managers and has tied the mission and goals to critical job elements for a significant portion of the positions at the employee level. This effort will continue through FY 2002 until all of the service's positions have been tied to the mission and goals of the service

**Taxpayer Protection and Rights**

**Issue**

The legislative changes required by the Restructuring and Reform Act of 1998 (RRA 98) continue to have a profound impact. Most RRA 98 provisions, including massive training programs for thousands of employees, have been modified or implemented. These reforms will be tested over the next 2 years. During this time, significant management attention will be required to evaluate the effectiveness of the reforms.

**FY 2001 Accomplishments**

The IRS, in conjunction with Treasury Tax Policy, has drafted legislative changes to Section 1203 to moderate its effect. The National Treasury Employees Union is in agreement with the changes and appropriate Congressional Staff Members have been briefed. The staff to the Senate Committee on Finance has asked the GAO to conduct an independent study of the effects of 1203 and provide recommendations to the Committee. The IRS awaits the results of the GAO's study.

In FY 2001, quarterly reviews and certifications were completed along with implementation of training programs to reinforce the reforms outlined in RRA 98.

For the taxpayer, a new Checkbox Designation feature was developed and implemented that allows the taxpayer to designate a third party authorization on any Form 1040 series return.

**Processing Returns & Implementing Tax Law Changes during the Filing Season**

**Issue**

The filing season impacts every American taxpayer and is, therefore, always a highly critical program. Many programs, activities and resources have to be planned and managed effectively for the filing season to be successful. Critical programming changes for the filing season must receive priority over other programming requests. As part of modernization and workload transition efforts, the ten processing centers are undergoing a transition whereby eight centers will process only individual tax returns, while two will process only business returns. At the same time, partnership returns (Forms 1065) and related Schedules K-1 for partnerships with more than 100 partners will begin being processed electronically.

**FY 2001 Accomplishments**

While major legislation (tax rebate) occurred in 2001 it did not happen during the traditional Jan – June period thought of as the filing season and is addressed in the accomplishments area of this document. However, the IRS did deliver a successful filing season in 2001. Total revenue collected was $2.1 trillion. We processed over 130 million individual returns, and issued over 92 million refunds. IRS representatives also met with 9.4 million taxpayers and we answered 108 million telephone calls and responded to 19.2 million letters. The sheer size of the numbers is just one indicator of the complexity and magnitude of our task.

Since 1998, we provided extended hours of telephone service during the filing season. We also put on more assistors at peak hours, rather than just during normal business hours. As mentioned, almost 108 million taxpayers called on one of our toll-free lines during FY 2001. We received 76 million automated and Teletax calls, and our live assistors handled 32 million taxpayer calls. Our San Patricio, Puerto Rico call site became fully operational in 2001 and will greatly assist us in providing better access and service to Spanish-speaking taxpayers.

Busy signals in FY 2001 averaged only 2.3 percent of calls. Nearly all callers now have almost immediate access to automated services, although some callers are forced to wait longer to receive assistor service. During the 2001 filing season, taxpayers that wanted to reach an assistor were successful 62.1 percentage of time, often requiring them to call back. Although this was an improvement over the previous year, these wait times are still unacceptable to both taxpayers and the IRS. We are using every method at our disposal, including modern technology, to address them.

In addition, we added 23 additional forms to the 1040-*e*-file program. And we will achieve a major milestone in the 2002 filing season – virtually all 1040 forms and schedules can be filed electronically and no paper signature document is required. We will also expand the electronic payment options available to taxpayers by accepting credit cards to pay installment agreements

and delinquent taxes. In addition, we will repeat a popular option from the 2001 filing season. Taxpayers who need a filing extension can get one automatically by making a simple phone call.

In 2001, we also better served the business community's Electronic Tax Administration needs. In September we introduced Electronic Federal Tax Payment System (EFTPS) OnLine, which allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. And businesses can now file on-line their Form 941 (Employers Quarterly Federal Tax Return), as well as Form 1065 (Reporting Partnership Income) and Form 940 (Employers Annual Federal Unemployment Tax Return). Individual taxpayers that make quarterly estimated tax payments could also use the system, eliminating paper forms and receiving on-line access to payment history.

The Internet proved to be an enormous growth area for ETA. Taxpayer use of our web site surpassed all records. Four years ago, *irs.gov* received 260 million hits. In FY 2001, we posted 2.6 *billion* hits with more than 103 million forms and publications downloaded. In 2001, we also launched the Small Business and Self-Employed Community web page. It is devoted to the needs of this important group of taxpayers who often confront more complex tax issues than those who have their taxes withheld by an employer. And in 2002, we will unveil a revamped IRS web site that takes us from being an information-only portal to a world-class transaction based gateway.

**Customer Service & Tax Compliance Initiatives**

**Issue**

Business processes and technology have been re-engineered to focus on providing world-class service to taxpayers. Resources allocated to compliance activities decreased and as a result, revenue collected decreased by $5 billion and gross accounts receivable increased by $41 billion.

**FY 2001 Accomplishments**

A government-wide survey released in December 2001 showed improved customer satisfaction among individual taxpayers, especially among those who file their returns electronically. The IRS posted an 11 percent increase in satisfaction among all individual tax filers since 2000 and a 22 percent increase since 1999. It was the largest favorable gain of the 30 federal agencies surveyed by the American Customer Satisfaction Index (ACSI).

One of the important reasons for the strong showing in the ACSI survey was the very high satisfaction rate among electronic filers. It was 77.2 points – higher than the previous year and nearly seven points higher than the national score for private sector services. It was the third year in a row that taxpayers using IRS *e*-file expressed increased satisfaction.

**Providing Quality Customer Service Operations**

**Issue**

In an effort to better serve taxpayers, management of the toll-free telephone system was centralized; hours of operation were expanded; significant enforcement resources were committed to answering telephones and a significant investment in new technology was made. In spite of these efforts, the level of customer demand on toll-free telephone lines during the 1999 filing season could not be satisfactorily managed. In addition to providing better telephone service, face-to-face service remains an important part of providing quality customer service.

**FY 2001 Accomplishments**

IRS enhanced the Intelligent Call routing system to increase the number of calls handled in an automated environment and to route calls to sites dedicated to specific types of work. We also upgraded field assistance sites to offer evening and weekend hours and multilingual translation services. Taxpayer Resolution Representatives have been trained to provide end-to-end services to individual taxpayers. In addition, the number of frontline employees, specialized agent groups and interpretive services were increased. In FY 2001 IRS established an “all Spanish” customer service site in Puerto Rico and we have plans to add quality reviewers to the site in FY 2002. In the electronic environment we increased the availability and accessibility of electronic products and services by better tailoring and targeting our market strategies to specific customer needs and expanding e-file options. Educational and outreach programs were tailored to specific customer needs with easy self-help options.

**Impact of Global Economy on Tax Administration**

**Issue**

The global economy is rapidly growing and generating increasingly sophisticated business transactions. Acceleration of world trade and e-commerce in the business world exceeds the government’s capacity to administer taxes. Significant improvements are needed in international compliance programs to focus on non-filing, transfers of assets by U.S. citizens to foreign trusts, foreign tax credit claims, and foreign-source income. Customer service and compliance programs, including pre and post filing, are being developed to meet the tax administration needs of this expanding customer segment.

**FY 2001 Accomplishments**

Partnerships were formed with key internal and external stakeholders to address issues and provide guidance to the customer population. The Understanding Multinational Project was used for representatives from three partner countries (Australia, United Kingdom and Canada); the U.S. steering committee and technical advisors to discuss joint initiatives and data/issue analysis. The project provides training courses in technical, investigative and managerial areas in the U.S., and foreign countries in conjunction with international organizations. A Border Compliance Meeting was conducted for technical advisors, territory managers, the revenue service representative from Mexico, and members of the Strategy, Research and Program

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Planning staff to discuss technical issues and establish an industry exchange meeting on the Food and Agricultural Industry Segment related to border issues. Qualified Intermediary (QI) agreements were executed with foreign banking institutions and QI-EIN numbers were assigned prior to the January 1st effective date of the new section 1441 withholding tax regulation. Working relationship with Federal Trade Commission and Securities and Exchange Commission were established to address the issue of Internet Identification. In addition, the new foreign withholding tax regime was implemented timely, including ensuring that foreign financial institutions meet requirements for renewal of QI agreements and qualified intermediaries comply with the terms of their QI agreements.

**Modernization of the Internal Revenue Service – Organizational Restructuring**

**Issue**

The ability to balance the goals of helping taxpayers comply with tax laws and improving overall compliance depends on successful modernization. This modernization effort encompasses every facet of operations, including the organizational structure. On October 1, 2000, a new organizational structure was put in effect to better meet taxpayer needs and to provide an improved work environment. However, the standup of the new organizational units is far from the last step in the modernization process, business practices must also be revamped to better meet taxpayer needs.

**FY 2001 Accomplishments**

Following RRA 98's directions, we designed and made substantial progress in implementing a new modernized IRS organized around customers with similar needs. The new organization focuses on providing service in three key program areas: pre-filing, filing, and compliance. The modernized IRS organization was officially inaugurated, or "stood up", on October 1, 2000. The final stages of implementation, including the redistribution of workload, will require another year through FY 2002.

**Revenue Protection – Minimizing Tax Filling Fraud; Noncompliance with EITC**

**Issue**

Subsequent to studies showing billions of dollars of Earned Income Tax Credit (EITC) noncompliance, Congress provided additional funding and enforcement tools to improve EITC compliance. In 1998, a five-year EITC compliance initiative directed at the major sources of EITC noncompliance was initiated. As a result, the number of EITC-related errors involving social security numbers had been reduced and millions of dollars in erroneous EITC claims have been stopped. However, there is still an unknown portion of erroneous EITC refunds that are likely attributable to factors other than fraud. Achieving full participation by eligible taxpayers; ensuring compliance through verification of taxpayers' eligibility; and, reducing inherent vulnerabilities (multiple use of dependent Social Security Numbers) continue to be high-risk areas. Additionally, despite extensive programs and efforts to detect and stop fraudulent claims, the ability to systemically identify refund schemes involving business returns and associated credits remains a challenge.

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**FY 2001 Accomplishments**

Mitigation of risk associated with minimizing tax filing fraud in the Earned Income Tax Credit (EITC) area were accomplished by implementation of a three-part strategy. This strategy includes education and outreach visits to offices with a high volume of EITC return preparers, visits by agents to review compliance with due diligence requirements, and "partnering" with Criminal Investigation to ensure investigation of known fraudulent EITC claims and schemes. The IRS also began a check of secondary social security and identification numbers associated with a qualifying child to reduce the number and amount of ineligible claims made under EITC to address erroneous refunds and compliance among taxpayers who claim the Earned Income Tax Credit (EITC). Future efforts in this area will focus on system changes to implement further EITC validation and compliance requirements. Also in 2001, the IRS issued two nationwide alerts and established a web section to alert taxpayers and practitioners not to fall victim to fraud and tax schemes that seem "to good to be true." They range from tax credits or refunds related to reparations for slavery to illegal ways to "untax" yourself. On November 15, 2001, the Justice Department filed lawsuits in federal courts in three states to crack down on one of these frivolous and bogus scams that claimed that Section 861 of the tax code exempts from taxation all domestic income earned by U.S. citizens.

In addition, in FY 2002, we will continue to emphasize improved compliance with the Earned Income Tax Credit (EITC) provisions of the tax code. Key to our efforts is the use of the Dependent Database (DDB). Using data provided by the Department of Health and Human Services and Social Security Administration, it is designed to identify potential non-compliant returns during returns processing. For example, when a child's Social Security Number is used on multiple returns, the database helps determine which taxpayer is likely to erroneously claim tax benefits on behalf of that child. We will also move beyond testing to using the DDB application nationwide as part of our Examination Program and for the identification of non-compliant taxpayers and paid preparers.

**Collect Unpaid Taxes**

**Issue**

Reliable and timely financial, operational and compliance data is not available to help target efforts to collect billions of dollars in unpaid taxes. As a result, the federal government is exposed to significant losses of tax revenue and compliant taxpayers bear an undue burden of financing the government's activities. While proceeding with modernization efforts, some key collection actions such as levies and seizures have declined since 1997. These declines may increase the incentives for taxpayers to either not report or underreport their tax obligations. Attempts to identify taxpayers that have not paid the taxes they owe are made through various enforcement programs. The IRS' inability to fully pursue such cases is attributable to a decrease in staff, reassignment of collection employees to support customer service activities, and additional staff time needed to implement certain taxpayer protections that were included in the IRS Reform and Restructuring Act of 1998. Additionally, inadequate financial and operational information has hindered development of cost-based performance information for tax collection and enforcement programs.

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**FY 2001 Accomplishments**

Accomplishments in this area are outlined in the section entitled Post-Filing Compliance Services and can be found on page 6.

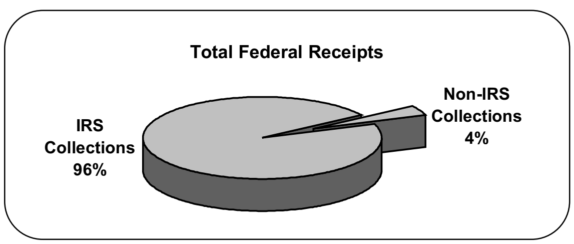
**5. Financial Statements and Stewardship Information Analysis**

**Overview of Revenue and Administrative Accounts**

The IRS' financial statements and footnotes received an unqualified audit opinion for the second consecutive year for administrative accounts and the fifth consecutive year for revenue accounts. Administrative accounts reflect resources used and expenses incurred in administering the tax laws. Revenue accounts reflect net taxes receivable and taxes collected to support the federal government.

The Balance Sheet reflects total assets of $25.24 billion. Of these assets, almost 79 percent are Federal Taxes Receivable. These receivables are the amounts expected to be collected from past due accounts. The decrease in assets of $1.37 billion is mainly attributable to a decrease in Federal Taxes Receivable. The majority of the liabilities, a little over 85 percent, consist of Federal Taxes Receivable due to Treasury.

The Statement of Custodial Activity shows that IRS programs resulted in $2.124 trillion in Federal receipts. IRS collections constitute 96 percent of the Federal Government receipts, as shown in the following chart.




Federal tax revenues are collected through six major classifications: individual income; corporate income; excise taxes; estate and gift taxes; railroad retirement; and, Federal unemployment taxes. Individual income taxes, which include FICA and SECA taxes, increased by 4.5 percent. Corporate income taxes decreased by 20.9 percent. Collections from all other tax sources were relatively stable from 2000 to 2001. The entire amount of Federal revenue received in 2001 was distributed to Treasury.

Federal tax refunds, which include tax, interest, the special tax rebate authorization, payments for Earned Income Tax Credits and Child Tax Credits in excess of the tax liability were $251 billion.

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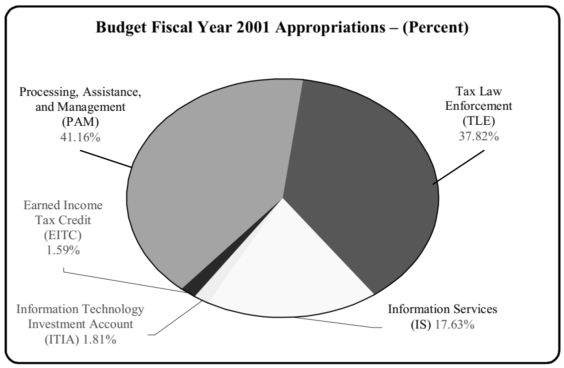
## Financing Sources

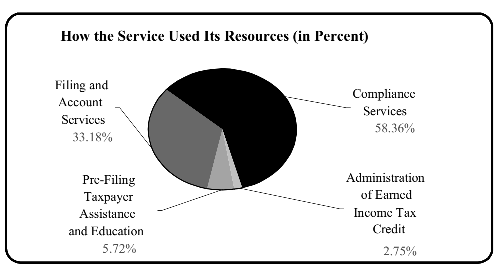
The IRS receives the majority of its funding through annual, multi-year, no-year and trust fund appropriations which are available for use within certain specified statutory limits. There are three major and several minor operating appropriations. The Processing, Assistance and Management appropriation funds the processing of tax returns and related documents, assistance for taxpayers in the filing of their returns and paying taxes due, matching information with returns, conducting internal audit reviews and security investigations, and managing financial resources. The Tax Law Enforcement appropriation provides funds for the examination of tax returns and the administrative and judicial settlement of taxpayer appeals of examination findings. The Information Services appropriation funds costs for data processing and information and telecommunications support for the Service's activities. The Investment Technology Investment Account and the Earned Income Tax Credit appropriations are the most significant of the minor operating appropriations. The former funds capital asset acquisitions of information technology systems. The latter provides resources for expanded customer service and outreach, strengthened enforcement, and enhanced research to reduce claims and erroneous filings associated with the Earned Income Tax Credit.




Besides appropriations, the Service utilizes other financing sources. These include net transfers from other federal agencies, and imputed financing (subsidies from other federal funds that pay for specific items such as payments for retirement benefits).

### Use of Resources

The Statement of Net Cost reflects the use of resources in carrying out the agency's major programs. The major programs are Pre-filing, Filing and Account Services, Compliance, and Administration of the Earned Income Tax Credit (EITC). Pre-filing activities include taxpayer education and outreach, pre-filing agreements, and tax publication issuance and distribution. Filing and account services activities include the filing of tax returns, current account status, and processing of taxpayer information. Compliance activities include document matching, audits, and criminal

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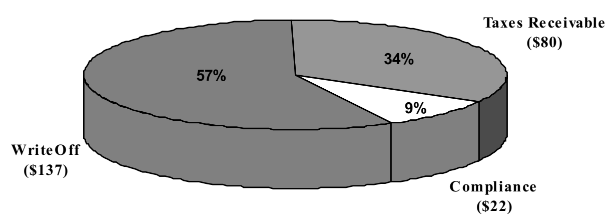
investigation activities. Administration of the EITC activities includes pre-filing, filing and account services, and compliance activities.

**Most Unpaid Assessments Are Not Receivables And Are Largely Uncollectible**

As reflected in the supplemental information to IRS' fiscal year 2001 Financial Statements, the unpaid assessment balance was about $239 billion as of September 30, 2001. This unpaid assessment balance represents assessments resulting from taxpayers filing returns without sufficient payment; as well as from the Service's enforcement programs such as Examination, Underreporter, Substitute for Return, and Combined Annual Wage Reporting. A significant portion of this balance is not considered a receivable. In addition, a substantial portion of the amounts considered receivables is largely uncollectible.

Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments with little or no future collection potential are called write-offs.
*Figure 1* depicts the components of the unpaid assessments balance as of September 30, 2001.

***Figure 1*: Components of IRS' $239 Billion of Unpaid Assessments**




Of the $239 billion balance of unpaid assessments, $137 billion represents write-offs. Write-offs principally consist of amounts owed by defunct taxpayer's and includes many failed financial institutions resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC). The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy.

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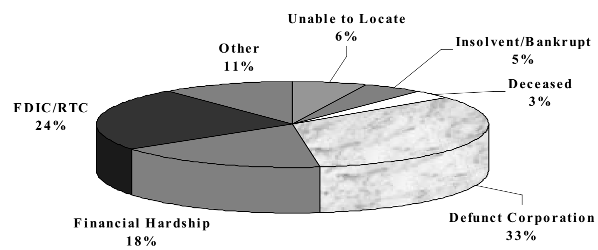
*Figure 2* depicts the components of the write off balance as of September 30, 2001.

***Figure 2*: Components of IRS' $137 Billion of Write offs**




In addition, $22 billion of unpaid assessments represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various Service enforcement programs to promote voluntary compliance. Due to the lack of agreement, these compliance assessments have less potential for future collection than the unpaid assessments that are considered federal taxes receivable.

The remaining $80 billion of unpaid assessments represent federal taxes receivable. About $60 billion (75%) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, including individual taxpayers who are unemployed, are currently in bankruptcy, or have other financial problems. However, under certain conditions, IRS may continue collection action for 10 years after the assessment. Thus, these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves.

About $20 billion, or about 25%, of federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals, confirmed payment plans through bankruptcy, and some newer amounts due from individuals and businesses with a history of compliance. The taxes receivable amount from September 30, 2000, to September 30, 2001, decreased $1 billion, from $81 billion to $80 billion. The percent estimated to be collectible at September 30, 2001 (25%), decreased from September 30, 2000 (27%).

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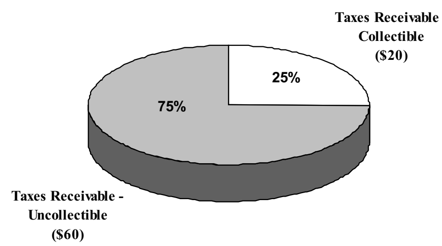
*Figure 3* depicts the taxes receivable balance that is considered collectible and uncollectible as of September 30, 2001.

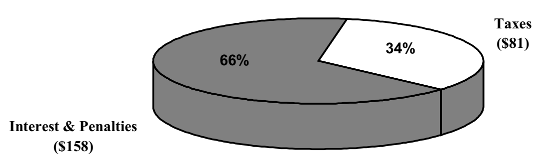
***Figure 3*: Components of IRS' $80 Billion of Taxes Receivable**




It is also important to note that the unpaid assessment balance contains unpaid assessed tax, penalty, and interest, and accrued penalty and interest computed through September 30, 2001. About $158 billion (66%) of the unpaid assessment balance as of September 30, 2001, contains interest and penalties, as depicted in *Figure 4*, and are largely uncollectible.

*Figure 4* depicts the Unpaid Taxes and Interest and Penalty Components as of September 30, 2001.

***Figure 4*: Unpaid Taxes and Interest and Penalty Components of $239 Billion in Unpaid Assessments**

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Interest and penalties are such a high percentage of the balance because IRS must continue to accrue them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, and on exam assessments where taxpayers have not agreed to the amount assessed. The overall growth in unpaid assessments during FY 2001 was mostly attributable to the accrual of interest and penalties.

## 6. Performance Goals, Objectives and Results

### Critical Measures/Indicators

The critical measures/indicators were selected by the IRS Commissioner as measurements of performance representing taxpayer facing activities. For FY 2001, the critical measures/indicators represent the agency at the strategic level and will be complemented by the IRS strategic measures in FY 2002. Experience has shown that development of performance measures continues to be an evolving process that improves with time. Beginning in FY 2002, the list of critical measures/indicators will be revised to include additional measures/indicators to more fully represent key processes and program areas.

The FY 2001 critical measures/indicators replace the key performance indicators displayed in the FY 2000 IRS Annual Report's Management Discussion and Analysis (MD&A). In addition, FY 1999 historical information is now provided to present a more complete historical picture of performance.

| AGENCY- WIDE OPERATIONAL PERFORMANCE MEASURES | Fiscal Year Performance | | | |
|---|---|---|---|---|
| | FY 1999 Actual | FY 2000 Actual | FY 2001 Actual | FY 2001 Plan |
| ***Pre-Filing Services -- Assisting Taxpayers in Understanding their Tax Responsibilities and Preparing Accurate Returns*** | | | | |
| **1. EP/EO Determination Letters** | 114,598 | 109,461 | **109,326** | 121,000 |
| **2. Private Letter Rulings Completed** | - | 1,913 | **2,428** | 1,920 |
| **3. Taxpayer Advocacy Projects** | - | 88 | **92** | 88 |
| ***Filing Services - Assisting Taxpayers in Filing Returns, Receiving Refunds, Making Payments and Resolving Questions about their Accounts*** | | | | |
| **4. Percent Individual Returns Filed Electronically** | 23.4% | 27.8% | **30.7%** | 32.6% |
| **5. Elect Fed Tax Payments System (millions)** | 55.3 | 63.4 | **64.4** | 67.5 |
| ***Toll-Free Telephone Service Effectiveness*** | | | | |
| **6. Toll-Free Customer Satisfaction** (4 point scale) | 3.50 | 3.50 | **3.45** | 3.58 |
| **7. Toll-Free Level of Service** | - | 59% | **56%** | 63% |
| **8. Toll-Free Tax Law Quality** | 74% | 73% | **75%** | 74% |
| **9. Toll-Free Account Quality** | 82% | 60% | **69%** | 63% |

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| AGENCY- WIDE OPERATIONAL PERFORMANCE MEASURES | Fiscal Year Performance | | | |
|---|---|---|---|---|
| | FY 1999 Actual | FY 2000 Actual | FY 2001 Actual | FY 2001 Plan |
| *In-Person Assistance to Taxpayers* | | | | |
| 10. Customer Satisfaction-Walk In (7 point scale) | 6.43 | 6.50 | **6.40** | 6.50 |
| *Post-Filing Compliance Services: -- Bringing Taxpayers into Compliance with the Law* | | | | |
| *Collection by Telephone* | | | | |
| 11. Telephone Customer Satisfaction-Automated Collection System (ACS) (4 point scale) | 3.32 | 3.41 | **3.46** | 3.50 |
| 12. ACS – Taxpayer Delinquent Accounts Closed (Entities) | 2,874,093 | 1,052,221 | **1,006,600** | 1,087,400 |
| 13. ACS – Taxpayer Delinquent Investigations Closed (Entities) | 1,828,885 | 412,150 | **297,791** | 400,376 |
| 14. ACS - Telephone Level of Service | 81% | 79% | **77%** | 80% |
| *In-Person Collection* | | | | |
| 15. Customer Satisfaction-Collection Field (7 point scale) | 3.89 | 4.60 | **5.01** | 4.94 |
| 16. Field Coll. - # of cases closed (TDA)(Modules) | 951,984 | 771,455 | **757,392** | 846,800 |
| 17. Field Coll. - # of cases closed (TDI) (Entities) | 166,808 | 144,764 | **119,451** | 146,211 |
| 18. Field Collection Quality | 86% | 84% | **84%** | 86% |
| *Cases of Under or Over Reporting Identified through Document Matching* | | | | |
| 19. Automated Underreporter Closures | 3,367,086 | 2,888,900 | **2,511,424** | 2,859,000 |
| 20. Automated Underreporter Quality | - | 93% | **95%** | 94% |
| *Examination of Returns Through Correspondence and Telephone* | | | | |
| 21. Service Center Exam - Customer Satisfaction (7 point scale) | 3.87 | 4.04 | **4.18** | 4.30 |
| 22. Service Center Exam - Number of Returns Examined | 1,302,700 | 394,754 | **650,376** | 558,655 |
| 23. Service Center Exam Quality | 91% | 70% | **71%** | 72% |
| *Examination of Returns In Person* | | | | |
| 24. Field Exam – Customer Satisfaction (7 point scale) | 4.08 | 4.41 | **4.65** | 4.60 |
| 25. Individual Return Examinations > $100,000 | 94,638 | 63,217 | **50,827** | 113,699 |
| 26. Individual Return Examinations < $100,000 | 289,698 | 187,891 | **145,144** | 152,964 |
| 27. Total Returns Examined | 384,336 | 251,108 | **195,971** | 266,663 |
| 28. Field Exam – Case Quality Score | 65% | 58% | **70%** | 60% |
| *Examination – Corporate Returns* | | | | |
| 29. Number of Returns Examined-General Industry | 137,893 | 103,112 | **84,748** | 142,441 |

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

| AGENCY- WIDE OPERATIONAL PERFORMANCE MEASURES | Fiscal Year Performance | | | |
|---|---|---|---|---|
| | FY 1999 Actual | FY 2000 Actual | FY 2001 Actual | FY 2001 Plan |
| 30. Number of Cases Examined (Large Case) | 416 | 369 | **417** | 475 |
| 31. Number of Returns Closed (Large Case) | 3,807 | 3,096 | **3,710** | 3,831 |
| *Employee Plans and Exempt Organizations* | | | | |
| 32. EP/EO Customer Satisfaction (7 point scale) | 5.43 | 5.71 | **5.70** | 5.70 |
| 33. EP/EO Examinations Closed | 22,525 | 19,080 | **15,988** | 19,300 |
| 34. EP/EO Examination Quality | - | 83% | **73%** | 83% |
| *Appeals* | | | | |
| 35. Appeals Cases Closed | 61,507 | 54,986 | **54,748** | 73,013 |
| *Taxpayer Advocate Service (TAS)* | | | | |
| 36. TAS Closed Cases | 294,993 | 237,885 | **248,011** | 244,941 |
| 37. Casework Quality Index | 79% | 65% | **72%** | 68% |
| *General Administration* | | | | |
| 38. Total Enforcement Revenue (billions)* | 32.90 | 33.80 | **33.78** | 34.00 |
| 39. Agency Wide Employee Satisfaction | 55% | 59% | **51%** | 60% |
| 40. FTE per Billion $ Real GDP* | - | 10.57 | **10.26** | 10.42 |

* *Identifies a Diagnostic Indicator*

**7. A Performance Discussion Immediately Follows the Definition for All Cases Where FY 2001 Performance Exceeded or Fell Below Plan by a Value Greater or Less Than Ten Percent**

1. **Employee Plans and Exempt Organization (EP/EO) Determination Letters –** Cases established on the Tax-Exempt and Government Entities (TE/GE) and EP/EO Determination System and closed on that system regardless of type of case or type of closing.
   **Performance Discussion:** The planned number of determination case disposals was predicated on the projected volume of application receipts. The shortfall was primarily due to an unexpected decline in receipts for plan amendments under new pension laws. Those receipts are expected in the first quarter of FY 2002 and will increase both receipts and cases closed for FY 2002. Determination closures were slightly (less than 2%) below plan due to an increase in time applied per case associated with new agent hires.
2. **Private Letter Rulings Completed –** Total number of Private Letter Rulings (PLRs) completed by the Office of the Chief Counsel. PLR's are written statements that address specific, tax-related issues pertaining to the taxpayer and the IRS about the tax treatment of particular matters before a taxpayer's return is filed. These techniques reduce taxpayer burden, eliminate controversy, and enhance voluntary compliance,

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

even before the taxpayer is involved. Private Letter Ruling program is the largest single program in Chief Counsel.

3. **Taxpayer Advocacy Projects –** Cumulative total of all Advocacy Projects to date, by fiscal year. An Advocacy Project is an Operating Division Taxpayer Advocate (ODTA) project in which an operational issue is identified that adversely affects a group of taxpayers.
4. **Percent of Individual Returns Filed Electronically –** The number of electronically filed individual tax returns divided by the total number of individual returns filed. Includes all returns where electronic filing is permitted (Practitioner e-file, Telefile, VITA [Volunteer Income Tax Assistance], On –Line Filing, Federal/State returns, etc.)
5. **Electronic Federal Tax Payments –** All individual and business tax type payments made directly through the Electronic Federal Tax Payment System (EFTPS), through IRS e-file, directly through payroll service providers, or through credit card processors.
6. **Toll-Free Customer Satisfaction –** Represents the customers' overall level of satisfaction with the services provided by the IRS Toll-Free program. Survey recipients are asked to rate IRS performance on a four-point scale, where 1 indicates *Very Dissatisfied* and 4 indicates *Very Satisfied*. Limitations on the survey data not affecting the statistical validity include: only customers calling one of the IRS toll-free telephone numbers are included in the sample. Calls are selected based on a sampling pattern that includes variables for the hour of day, day of week, and time of year. Customers calling when IRS monitors are not available (Saturday, Sunday and some evening hours) are excluded from the survey.
7. **Toll Free Customer Service Representative (CSR) Level of Service –** Reported as the percentage of taxpayers that are calling our toll-free services and speak to an assistor. Factors used to arrive at the level of service provided by assistors and taken into consideration in the calculation: Callers selecting an automated application, receiving a busy signal or abandoning while in queue waiting for an assistor. In FY 2001, the methodology used to calculate results of this measure were changed, however, historical data was re-calculated using the new methodology in order to present a complete historical picture.
   **Performance Discussion**: The level of service for the full fiscal year was significantly affected by the large volume of calls during July, August, and September due to the special advance refund, resulting in longer wait times and a lower than planned assistor level of service despite answering approximately the planned number of assistor calls. During the filing season period, which ended before the special refund calls began to come in, assistor level of service was at 64 percent an increase of 5.13 percent from the 2000 filing season level. The fiscal year variance from target was caused primarily by longer handle times for account calls, which in turn is partly due to the diversion of more simple calls to automated services.
8. **Toll-Free Tax Law Quality –** The percentage of customers receiving accurate responses to their Tax Law inquiries. This evaluates the customer (external), administrative (internal) and regulatory accuracy of this service.
9. **Toll-Free Account Quality –** The percentage of customers receiving accurate responses to their account inquiries. This evaluates the customer (external), administrative (internal) and regulatory accuracy of this service.
   **Performance Discussion:** Increased attention placed on quality, and an increase in the knowledge and experience of the Customer Account Representatives as the year progressed were factors in the significant increases in work quality in the account area.
10. **Customer Satisfaction – Walk-in –** Represents the customers' overall level of satisfaction with the services provided by the IRS at its Taxpayer Assistance Centers.

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

The scores represent the average overall level of customer satisfaction (“Keystone” question) from the Customer Satisfaction transactional surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*.

11. **Telephone Customer Satisfaction – Automated Collection System (ACS) –** Represents the customer’s perception of IRS service received through contact with employees in the Automated Collection System call centers. Limitations on survey respondents not affecting the statistical validity are as follows: ACS outgoing calls are not included in the survey due to technological limitations, and customers calling when IRS monitors are not available (Saturday, Sunday and some evening hours) are excluded from the survey. In FY 2002 IRS will implement customer satisfaction surveys at its call center site dedicated to the Spanish-speaking community.
12. **Automated Collection System Closures – Taxpayer Delinquent Accounts (TDA) –** Number of entity delinquent account closures produced in the Automated Collection System. Entities closed using codes related to systemic reduction of inventory are not included in the actual count.
13. **Automated Collection System Closures, Taxpayer Delinquent Investigations (TDI) –** Number of entity delinquent investigation closures produced in the Automated Collection System. Entities closed using codes related to systemic reduction of inventory are not included in the actual count.
    **Performance Discussion:** The target was determined to be flawed after identification of a systemic problem inflating the base used to develop the FY 2001 goals. In addition, the need to provide staff to answer the increased call volumes was a primary contributing factor to the missed target as were delays in hiring and greater focus placed on working the delinquent account inventory.
14. **Automated Collection System -Telephone Level of Service –** Percentage of calls attempted compared to the number of calls answered by the next available assistor in the Automated Collection System call centers. Calls which abandon after having been answered but while in queue waiting for an assistor are not included in the count of calls answered. Taxpayers who receive a busy signal while trying to reach a call center are not factored into the calculation. In FY 2002 the definition will be changed to mirror the definition for Toll-Free Customer Service Representative (CSR) level of service and will include factors such as busy signals.
15. **Customer Satisfaction – Collection Field –** Represents the Customers’ overall level of satisfaction with the way their cases were handled by employees in the IRS Field Collection program. Scores represent the average overall level of customer satisfaction (“Keystone” question) from the Customer Satisfaction transactional surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*. Limitations not affecting the statistical validity of the sample include: sampling only those customers who owe money to the IRS and have been referred to Collection are sampled. Additionally, samples drawn from the Collection Quality Measurement System (CQMS) database only include three types of closures; Currently Not Collectible/Hardship, Installment Agreements, and Full Pays. The sample does not include: cases with no case history, cases for customers the IRS cannot locate, cases where the statute has expired, bankruptcy cases, deceased taxpayers, and defunct or insolvent corporations. For cases involving an Offer in Compromise, only those offers that are accepted by the IRS are included. Upon conversion of the Integrated Collection System (ICS) database the survey will be expanded to include the entire range of Collection cases.

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

16. **Field Collection, Number of Cases Closed Taxpayer Delinquent Account (TDA) –** A count of the number of actual TDA dispositions completed by field Revenue Officers on a monthly basis. A TDA disposition arises on yhe Integrated Data Retrieval System (IDRS) when the status of an account changes from an open status to any closed status as defined in Section 8 (Document 6209 - Automated Data Processing (ADP)/IDRS Information.) Data is reported as modules.
**Performance Discussion**: The top priority was to stem the long-term decline in the TDA Taxpayer Delinquent Account (TDA) closures, which were approximately level with closures in FY 2000. The number of closures were impacted by a resource shift to work Offer In Compromise cases, increased complexity of SB/SE inventory, Collection Due Process procedures and additional process steps still in place from the Restructuring and Reform Act of 1998
17. **Field Collection – Number of Cases Closed Taxpayer Delinquent Investigation (TDI) –** Count of the number of actual TDI dispositions completed by field Revenue Officers on a monthly basis. A TDI disposition arises on Integrated Data Retrieval System (IDRS) when the status of an investigation changes from an open status to a closed status (any) as defined in Section 8 of Document 6209 (Automated Data Processing (ADP)/IDRS Information.) Data is reported as entities.
18. **Field Collection Quality –** Score awarded to a reviewed Collection case by a third-party reviewer using the Collection Quality Measurement System (CQMS) quality standards. Each standard if met, has a value. Values are totaled to arrive at the score with deductions in the overall composite score for failure to meet a standard designated as critical.
19. **Automated Underreporter (AUR) Closures –** Total number of closures of Automated Underreporter Cases.
**Performance Discussion:** A delay in starting the Tax Year 1999 inventory due to systemic problems, coupled with a reduction in the number of immediate closures screened out on the front end of the process (29% versus the planned 40%) contributed to an inventory shift to more complex SB/SE cases and were direct contributors in failure to meet the target.
20. **Automated Underreporter (AUR) Quality –** Quality of all AUR account actions as a result of taxpayer inquiries or internal requests. Quality of casework in the undereporter area is performed on closed cases only.
21. **Service Center Examination Customer Satisfaction –** Represents the level of satisfaction customers receive from interactions with the IRS Service Center Examination services. Respondents are asked to rate the IRS using a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*. Limitations not affecting the statistical validity of the sample include: sole proprietors and self-employed individuals and farmers, as well as individual shareholders and partners examined as a result of a corporate audit are included in the sample. The sample does not include businesses that file corporate and partnership returns, individuals who did not respond to correspondence and audit appointment letters, individuals IRS cannot locate and individuals with an international address.
22. **Total Number of Service Center Exams Returns Examined –** Number of cases closed by employees assigned to the service center examination branch.
**Performance Discussion**: A decision by management to redirect resources to work through the backlog of inventory in the Earned Income Tax Credit (EITC) area was successful. The additional resources and the less complex examination of an EITC return caused an increase in productivity and subsequently, results over the planned target.

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

23. **Service Center Examination Quality –** Quality of actions taken while working service center examination cases. Quality review of the sampled cases is completed and a review record produced by the quality reviewer at each designated site.
24. **Field-Exam Customer Satisfaction –** Represents the level of satisfaction customer's receive from interactions with IRS Field Examination employees. Scores represent the average overall level of customer satisfaction ("Keystone" Question) from the Customer Satisfaction Transactional Surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*. Limitations on survey data not affecting the statistical validity include: the survey population is based solely on the audit closures of individual taxpayers. Audit closures involving estate, corporate, excise and gift tax returns are not included in the survey population. The results do not include contacts the Examination division had with individuals that did not result in an audit closure.
25. **Individual Return Examinations > $100K –** Number of Individual (Form 1040) returns closed through a time period from the beginning of the fiscal year with a total positive income or total gross receipts greater than $100,000.
    **Performance Discussion:** The original plan assumed increases in resources; percentages of direct time applied, and reduction in the time per return. These improvements were not realized resulting in fewer returns closed. Immediate emphasis has been placed on building and maintaining optimal inventory levels, case management and issuance of revised program guidance.
26. **Individual Return Examinations < $100K –** Number of Individual (Form 1040) returns closed through a time period from the beginning of the fiscal year with a total positive income or total gross receipts less than $100,000.
27. **Total Returns Examined –** Combined count of the Number of Individual (Form 1040) returns closed through a time period from the beginning of the fiscal year with a total positive income or total gross receipts less than or greater than $100,000.
    **Performance Discussion:** The original plan assumed increases in resources; percentages of direct time applied, and reduction in the time per return. These improvements were not realized resulting in fewer returns closed. Immediate emphasis has been placed on building and maintaining optimal inventory levels, case management and issuance of revised program guidance.
28. **Field-Exam Case Quality Score –** The score awarded to a reviewed Field Examination case by a Quality Reviewer using the Examination Quality Measurement System (EQMS) quality standards.
    **Performance Discussion:** The apparent increase in case quality score in FY 2001 is due to changes in the case quality point scale and number of standards measured, as compared to FY 2000.
29. **Number of Returns Examined General Industry –** Includes Industry returns closed. Includes all classes of returns.
    **Performance Discussion:** The FY 2001 planning assumptions were made with limited historical information. Also, there was a larger than expected expenditure of time in areas that do not ordinarily result in a closed case. Accordingly, the number of returns that were planned did not materialize.
30. **Number of Cases Examined (Large Case) –** Number of regular Coordinated Industry cases closed during the period ("R1" cases; i.e., not including claim cases, cases returned from Appeals, or non-examined closures). A Coordinated Industry case consists of one or more tax years of the primary taxpayer (usually a large corporate return) plus all related returns examined in conjunction with the primary taxpayer.

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

**Performance Discussion:** The increase in cases examined in FY 2001, as compared to FY 2000, is attributed to a large number of staff re-directed to case examination. In FY 2000, a large number of staff within LMSB were engaged in design teams activities focused on organization and stand up.

31. **Number of Returns Closed (Large Case) –** Coordinated Industry corporate returns (F1120) closed with designated activity codes.
32. **EP & EO Customer Satisfaction –** Customers' overall level of satisfaction with the way their cases were handled by the IRS EP & EO Determination programs. Scores represent the average overall level of customer satisfaction ("Keystone" Question) from the Customer Satisfaction Transactional Surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*.
33. **EP & EO Examinations Closed –** Number of EP & EO return examinations closed in all categories.
    **Performance Discussion:** A surge in determination receipts was expected and inventories of open examination cases were kept low in order to ensure a smooth transition of agents from working examinations to determinations. When the anticipated volume of determination receipts did not materialize, additional returns were placed in process. Many of the additional returns were larger plans that require longer processing time and resulted in fewer returns closed than expected.
34. **EP & EO Examination Quality –** Level of quality in the EP & EO examination program, as measures by the Tax Exempt Quality Measurement System (TEQMS).
    **Performance Discussion:** The overall decline in quality was primarily attributed to the Examination Planning and Workpaper standards which were found to be inconsistent with current work processes and require modification. These quality standards were addressed through targeted training sessions in FY 2001 and emphasis on quality will continue during regular training for all agents.
35. **Appeals Cases Closed –** Total Cases Closed (Total Disposals) equals the total number of cases closed in Appeals. This includes both non-docketed and docketed cases. (A docketed case is one in which a taxpayer has filed a petition in the Tax Court.) This measure is currently reported in workunits. A workunit represents a single case or group of related cases, which are being considered by Appeals as one unit for settlement of decision purposes.
    **Performance Discussion:** The Appeals workload continued to shift from examination to predominantly collection-type work, including Collection Due Process. Resources were diverted to accommodate the dramatic increase in Collection work and a comprehensive training program of retraining and mentoring existing personnel to handle this new source of work was initiated. The impact of diverting resources and retraining existing personnel to accommodate the shift in workload contributed to an increase in cycle time and subsequently, lower than planned productivity.
36. **Taxpayer Advocate Service (TAS) Closed Cases –** Number of cases worked in TAS and closed on the Taxpayer Advocate Management Information System (TAMIS).
37. **Casework Quality Index –** Tool to measure effectiveness in meeting customer expectations based on a random sample of cases reviewed and scored against customer service standards of timeliness, accuracy, and communication.
38. **Total Enforcement Revenue Collected (billions) –** Revenue received as a result of activities performed by enforcement functions. This revenue is collected through the efforts of Appeals, Chief Counsel, Collection, Examination, and the Information Return Processing (IRP)/Underreporter program are captured.

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

39. **Agency-Wide Employee Satisfaction –** Measure of employee's satisfaction with their job at the IRS. At the Service-wide level the results of Survey Item CO 1 (Considering everything, how satisfied are you with your job?) are used as the sole determining factor in the reported results. Additionally, survey questions regarding the employees perception of management practices, organizational barriers, and overall work environment that impacts an employees' efforts to do a good job are used in the results. **Performance Discussion:** The measurement definition was changed from FY 2000 to FY 2001 so results are not fully comparable. Nevertheless, the numbers show a decline in FY 2001, which can be attributed to the effects of the reorganization, which are also showing up as negative results in the Climate Survey. The IRS Commissioner has made improving employee satisfaction results the responsibility of each individual manager (an element in each manager's performance plan) and every Operating and Functional Division (OD and FD's). Divisions are now analyzing their census survey results in light of their Climate Survey data to determine what (if any) additional Division-level responses are needed.
40. **FTE per Billion $ Real GDP –** Service-wide Employment as a proportion of national expenditures.

**8. Systems Controls and Legal Compliance**

**Federal Manager's Financial Integrity Act (FMFIA)**

In accordance with the FMFIA, the IRS evaluated its systems of internal controls for FY 2001. The IRS is providing a "qualified assurance" that Section 2 and Section 4 objectives are being achieved. Overall, the IRS internal control systems are adequate in achieving the objectives of the Integrity Act. This qualified assurance is based on our identification of material weaknesses and national significant control deficiencies. All weaknesses and deficiencies are being addressed by corrective action plans.

During the year, the Financial and Management Controls Executive Steering Committee (FMC ESC) reviewed audit findings and Service operations. This summer, IRS managers conducted a thorough self-assessment of the management controls for their operations and reported issues for National Headquarters review. The Business Owners reviewed the issues and recommended to the FMC ESC the actions taken or planned for each issue. The FMC ESC also reviewed existing weaknesses and national significant control deficiencies throughout the year to ensure progress was being made. They also gave the final determination about officially closing items. During the fiscal year, the IRS closed three material weaknesses and opened two.

**Federal Financial Management Improvement Act (FFMIA)**

As of September 30, 2001, the Service's financial management systems did not substantially comply with the FFMIA. Plans are in place to resolve the material weaknesses causing this condition, and the initiatives associated with these plans are in the IRS Modernization Bluebook.

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

**Performance Measures**

The Service provides assurance that the IRS Critical Performance Measures are reliable.

**Laws and Regulations**

As of September 30, 2001, the IRS did not always comply with Section 6325 of the Internal Revenue Code regarding the release of federal tax liens although significant improvement over prior year was realized.

**Continuity of Operations and Reports Consolidation Act of 2000**

The IRS is addressing continuity of operations planning in critical areas. Subsequent to the events of September 11, 2001, actions were taken to assess baseline business processes and to enhance capabilities where needed. These actions included improving the disaster recovery capabilities at the Computing Centers, which had been reported as a significant control deficiency. Because the September 11th terrorist attacks increased the risk associated with this deficiency, the IRS is placing more emphasis on strengthening its disaster recover capabilities. Accordingly, *Computing Center Security* is being designated as a material weakness.

**9. Trends, Issues, Problems**

Success in achieving IRS' mission, goals, and objectives is influenced by the environment in which we operate and determines the strategies we use to achieve our goals. Each of the IRS' major organizational units conducted an assessment of their internal and external environment to identify trends, issues, and problems (TIPS) that were affecting business operations. They identified dozens of TIPS and developed strategies to address them. The most significant TIPS have been organized around twelve themes: Service to Taxpayers; Communication with Taxpayers; Pre-filing Agreements; Electronic Tax Administration; Complexity of the Tax Law; Global Trading; Compliance Services; Areas of Low Compliance; Measuring Compliance; Human Resources Issues; Technology in Support of Business Operations; and Shared Services in Support of Business Operations.

For the IRS to better understand the problems experienced by its customers, the Taxpayer Advocate Service (TAS) reported on its "23 most serious problems list," as presented in the FY 2001 Annual Report to Congress. This listing was compiled through TAS casework data as well as input from the Citizen Advocacy Panels, the opinions of the external stakeholder groups, and finally the internal stakeholders. Tax code complexity remains a significant problem for both business and individual taxpayers and is the root-cause of many other problems on the "Top 23" list. Leading the list in this report are:

1. Access to Customer Service Toll-Free Telephone Service
2. Multiple Definitions of "Qualifying Child"
3. Determining Earned Income Tax Credits (EITC)
4. Answers to Questions on Customer Service Toll-Free lines
5. Documenting Earned Income Tax Credit (EITC eligibility
6. Refund Inquiries

**INTERNAL REVENUE SERVICE**
**Management Discussion and Analysis**
**For the Fiscal Year Ended September 30, 2001**

7. Earned Income Tax Credit (EITC Examinations
8. Understanding Estimated Tax Payments
9. Explanations on Math Error Notices; and
10. Processing Claims for Refund

A uniform process has been established to address each problem as follows: each reported problem is assigned a responsible IRS official, problem definitions, analysis of problem, IRS comments, IRS initiatives to resolve problem, information technology impact and TAS comments. This information feeds into a system of periodic reviews.

The National Taxpayer Advocate has also made legislative recommendations in the following areas which are intended to simplify tax reporting, thereby reducing burden to taxpayers and the IRS: family status issues, joint and several liability, alternative minimum tax for individuals, penalties and interest, home-based workers, IRS collection procedures, and additional recommendations.

**10. Limitations of the Financial Statements**

The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b). While the statements have been prepared from the books and records of the entity in accordance with generally accepted accounting principles (GAAP) for Federal entities and the format prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

Department of the Treasury
Internal Revenue Service

FINANCIAL STATEMENTS

Fiscal Year 2001

## Balance Sheets

**Department of the Treasury**
**Internal Revenue Service**
**Balance Sheets**
**As of September 30, 2001 and 2000**

*(In Millions)*

| | 2001 | 2000 |
|---|---|---|
| **ASSETS** | | |
| Intragovernmental: | | |
| Fund balance with Treasury and cash (Note 2) | $ 2,070 | $ 2,008 |
| Due from Treasury (Note 12) | 1,419 | 1,040 |
| Accounts receivable, Net (Note 3) | 33 | 11 |
| Advances to government agencies | 128 | 163 |
| Total Intragovernmental | 3,650 | 3,222 |
| With the Public: | | |
| Federal Taxes receivable, net of Allowance for doubtful accounts (Notes 5, 12) | 20,000 | 22,000 |
| Accounts receivable, Net (Note 3) | 3 | 4 |
| Advances to the public | 15 | 14 |
| Other assets (Note 4, 12) | 195 | 93 |
| Total with the Public | 20,213 | 22,111 |
| Property and equipment, Net (Note 6) | 1,381 | 1,266 |
| **Total Assets** | **$ 25,244** | **$ 26,599** |
| **LIABILITIES** | | |
| Intragovernmental: | | |
| Due to Treasury (Notes 5, 12) | 20,000 | 22,000 |
| Accrued expenses (Note 7) | 89 | 71 |
| Other liabilities (Note 8) | 81 | 87 |
| Total Intragovernmental | 20,170 | 22,158 |
| Federal tax refunds payable (Note 12) | 1,419 | 1,040 |
| Accounts payable (Note 7) | 27 | 43 |
| Accrued expenses (Note 7) | 608 | 513 |
| Other liabilities (Note 8) | 1,071 | 909 |
| Capital lease liability (Note 9) | 125 | 21 |
| Contingencies (Note 10) | 6 | 12 |
| **Total Liabilities** | **$ 23,426** | **$ 24,696** |
| **NET POSITION** | | |
| Unexpended Appropriations | 1,380 | 1,385 |
| Cumulative Results of Operations | 438 | 518 |
| **Total Net Position** | **$ 1,818** | **$ 1,903** |
| **Total Liabilities and Net Position** | **$ 25,244** | **$ 26,599** |

*The accompanying notes are an integral part of these statements*

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## Statement of Net Cost

**Department of the Treasury**
**Internal Revenue Service**
**Statement of Net Cost**
**For the Fiscal Year Ended September 30, 2001**

***(In Millions)***

| **Program** | **Full Cost** | **Exchange Revenue** | **Net Cost of Operations** |
|---|---|---|---|
| Pre-Filing Taxpayer Assistance and Education | $ 579 | (48) | $ 531 |
| Filing and Account Services | 3,099 | (18) | 3,081 |
| Compliance Services | 5,601 | (170) | 5,431 |
| Administration of Earned Income Tax Credit | 255 | - | 255 |
| **Net Cost of Operations** (Note 17) | **$ 9,534** | **$ (236)** | **$ 9,298** |

*The accompanying notes are an integral part of these statements*

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## Statements of Changes in Net Position

**Department of the Treasury**
**Internal Revenue Service**
**Statements of Changes in Net Position**
**For the Fiscal Years Ended September 30, 2001 and 2000**

*(In Millions)*

| | 2001 | 2000 |
|---|---|---|
| **Net Cost of Operations** | **$ 9,298** | **$ 8,723** |
| **Financing Sources (other than exchange revenue)** | | |
| Appropriations used | 8,844 | 8,344 |
| Transfers (to)/from General Fund and other | (32) | (48) |
| Imputed financing | 406 | 396 |
| **Total Financing Sources** | **9,218** | **8,692** |
| **Net Results of Operations** | **(80)** | **(31)** |
| **Net Change in Cumulative Results of Operations** | **(80)** | **(31)** |
| **Increase/(Decrease) in Unexpended Appropriations** | **(5)** | **(179)** |
| **Change in Net Position** | **(85)** | **(210)** |
| **Net Position – Beginning of Period** | **1,903** | **2,113** |
| **Net Position – End of Period** | **$ 1,818** | **$ 1,903** |

*The accompanying notes are an integral part of these statements*

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## Statements of Budgetary Resources

**Department of the Treasury**
**Internal Revenue Service**
**Statements of Budgetary Resources**
**For the Fiscal Years Ended September 30, 2001 and 2000**

*(In Millions)*

| | 2001 | 2000 |
|---|---|---|
| **Budgetary Resources** | | |
| Budget authority | $ 9,114 | $ 8,319 |
| Unobligated balances – beginning of period | 791 | 933 |
| Spending authority from offsetting collections | 121 | 107 |
| Adjustments (Note 18) | (78) | (12) |
| **Total Budgetary Resources** | **$ 9,948** | **$ 9,347** |
| **Status of Budgetary Resources** | | |
| Obligations incurred (Note 11) | $ 9,507 | $ 8,556 |
| Unobligated balances – available (Note 2) | 196 | 346 |
| Unobligated balances – unavailable (Note 2) | 245 | 445 |
| **Total Status of Budgetary Resources** | **$ 9,948** | **$ 9,347** |
| **Outlays** | | |
| Obligations incurred (Note 11) | $ 9,507 | $ 8,556 |
| Less: Spending authority from offsetting collections and adjustments | (231) | (180) |
| Obligated balance, net – beginning of period | 1,232 | 1,240 |
| Less: Obligated balance, net – end of period | (1,635) | (1,232) |
| **Total Outlays** | **$ 8,873** | **$ 8,384** |

*The accompanying notes are an integral part of these statements*

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## Statements of Financing

**Department of the Treasury**
**Internal Revenue Service**
**Statements of Financing**
**For the Fiscal Years Ended September 30, 2001 and 2000**

*(In Millions)*

| | 2001 | 2000 |
|---|---|---|
| **Obligations and Nonbudgetary Resources** | | |
| Obligations incurred | $ 9,507 | $ 8,556 |
| Less: Spending authority from offsetting collections and adjustments | (231) | (180) |
| Financing source – imputed financing | 406 | 396 |
| Exchange revenue not in the budget | (121) | (115) |
| Transfer of fixed assets | - | (8) |
| **Total Obligations, as Adjusted, and Nonbudgetary Resources** | **$ 9,561** | **$ 8,649** |
| **Resources That Do Not Fund the Net Cost of Operations** | | |
| Change in amount of goods, services, and benefits ordered but not yet received or provided | $ (324) | $ 24 |
| Change in unfilled customer orders | - | (1) |
| Costs capitalized on the Balance Sheet | (410) | (380) |
| Financing sources that fund costs of prior periods | - | 8 |
| **Total Resources That Do Not Fund the Net Cost of Operations** | **$ (734)** | **$ (349)** |
| **Costs That Do Not Require Resources** | | |
| Depreciation and amortization | $ 331 | $ 362 |
| Expenditure offset for pending refund | - | 5 |
| **Total Costs That Do Not Require Resources** | $ 331 | $ 367 |
| **Financing Sources Yet to be Provided** | $ 140 | $ 56 |
| **Net Cost of Operations** | **$ 9,298** | **$ 8,723** |

*The accompanying notes are an integral part of these statements*

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## Statements of Custodial Activity

**Department of the Treasury**
**Internal Revenue Service**
**Statements of Custodial Activity**
**For the Fiscal Years Ended September 30, 2001 and 2000**

*(In Billions)*

| | 2001 | 2000 |
|---|---|---|
| **REVENUE ACTIVITY** | | |
| **Collections of Federal Tax Revenue (Note 15)** | | |
| Individual income, FICA/SECA, and other | $ 1,844 | $ 1,765 |
| Corporate income | 187 | 235 |
| Excise | 52 | 55 |
| Estate and gift | 29 | 29 |
| Railroad retirement | 5 | 5 |
| Federal unemployment | 7 | 7 |
| **Total Collections of Federal Tax Revenue** | **2,124** | **2,096** |
| Increase/(Decrease) in federal taxes receivable, net | (2) | 1 |
| **Total Federal Tax Revenue** | **2,122** | **2,097** |
| Distribution of federal tax revenue to Treasury | 2,124 | 2,096 |
| Increase/(Decrease) in amount due to Treasury | (2) | 1 |
| **Total Disposition of Federal Tax Revenue** | **2,122** | **2,097** |
| **NET FEDERAL REVENUE ACTIVITY** | **$ -** | **$ -** |
| **FEDERAL TAX REFUND ACTIVITY (Note 16)** | | |
| **Total Refunds of Federal Taxes** | **$ 251** | **$ 194** |
| **Appropriations Used for Refund of Federal Taxes** | **(251)** | **(194)** |
| **NET FEDERAL TAX REFUND ACTIVITY** | **$ -** | **$ -** |

*The accompanying notes are an integral part of these statements*

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## Notes to the Financial Statements

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 1. Summary of Significant Accounting Policies**

**A. Reporting Entity**

The Internal Revenue Service (the Service) is a bureau of the U.S. Department of the Treasury (Treasury). The Service originated in 1862, when Congress established the Office of the Commissioner of the Internal Revenue. In 1952, the Bureau was reorganized by Congress and in 1953 became the Internal Revenue Service (IRS).

In FY 2001, the Service completed the implementation of a plan to reorganize its structure and management in accordance with the IRS Restructuring and Reform Act enacted by Congress in 1998. The Service implemented a modernized structure built around taxpayer needs. The revamped organization consists of :

- Four operating divisions – Wage and Investment addresses the needs of taxpayers with wage and investment income only. Small Business and Self-Employed serves self-employed individuals and small businesses. Tax-Exempt and Government Entities supports employee plans, tax exempt organizations, and government entities. Large and Mid-Size Business serves corporations, sub-chapter S corporations, and partnerships with assets greater than $5 million. Each of these divisions performs the functions of processing and examination of tax returns for its constituent taxpayers. Wage and Investment performs collection activities related to its own customers. Small Business and Self-Employed performs collection activities on its customer accounts as well as those of Tax Exempt and Government Entities and Large and Mid-Size Business.
- Two service organizations – Modernization and Information Technology Services and Agency Wide Shared Services provide central support to all areas of the Service;
- Separate specialized independent channels for taxpayers – Appeals and Taxpayer Advocate Service divisions are independent of the operating divisions and other units of the Service. The Taxpayer Advocate Service reports directly to Congress.
- A line unit, Criminal Investigation, has sole responsibility for investigation of criminal violations of the tax law and is independent of the operating divisions;
- Chief Counsel provides tax advice, guidance, and legislative services to all components of the Service; and
- A smaller National Headquarters office fills the role of setting broad policy, providing executive oversight, reviewing plans and goals of the operating units, and developing major improvement initiatives.

The mission of the Service is to provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

**B. Basis of Presentation**

The accompanying financial statements report the Service's financial position as of September 30, 2001 and 2000, and its changes in net position, budgetary resources, financing, and custodial activity for the years then ended. The net cost of operations is reported for the fiscal year (FY) ended September 30, 2001. The Office of Management and Budget (OMB) issued a waiver exempting the Service from including the net cost of operations for the fiscal year ended September 30, 2000 in the accompanying financial statements. The waiver was granted due to a change in basis of presentation between FY 2001 and FY 2000 for the statement of net cost. In FY 2000 program costs were presented for individual major functional areas of the Service. In FY 2001 program costs are aggregated into broader categories associated with pre-filing assistance, filing and account maintenance, and compliance activities. The single exception to this is EITC, which spans all activities—pre-filing, filing and compliance—associated with administration of the EITC program.

These statements include the accounts of all funds under the Service's control, which have been established to account for the resources of the Service, as well as funds for the purpose of recording tax revenues and refunds. They were prepared from the Service's accounting and financial management systems in accordance with OMB Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, as amended, portions of OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements* effective in FY 2001, and the Service's accounting policies which are summarized in this note.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

### C. Basis of Accounting

The accompanying financial statements are presented on a basis in accordance with generally accepted accounting principles (GAAP).

**Balance Sheets, Statements of Changes in Net Position**
These statements are presented on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned, and expenses are recognized when costs are incurred or goods or services are received, without regard to receipt or payment of cash.

**Statement of Net Cost**
The statement of net cost presents the full costs incurred by the Service in performing its mission, net of related exchange revenues. Full costs include direct costs, indirect costs assigned in a manner that reflects direct consumption of resources, and a proportionate share of other indirect costs. Where practicable, indirect costs are assigned directly. Where not practicable, they are allocated on a reasonable and consistent basis. General and administrative expenses (G & A) are included in indirect costs. G & A includes costs for headquarters administration, human resources, equal employment opportunity, education, procurement, general legal services and other miscellaneous administrative services.

In FY 2001 program costs are aggregated across divisional lines into broad-based cost centers - pre-filing, filing, compliance and Earned Income Tax Credit--described below. In general, these cost centers encompass all costs within the span of their activities. However, in the case of Earned Income Tax Credit, costs are segregated from other pre-filing, filing, and compliance activities, and reported in a separate program.

Exchange revenues include user fees from the public and reimbursable revenue from other government agencies. They are reflected as offsetting revenues against related program costs.

The majority of user charges are fees for installment agreements and determinations of tax-exempt status. Installment agreement fees are set at an amount below full cost. Fees for certain determinations are also set below full cost. Additionally, reimbursable fees are set below full cost; these fees are based on incremental costs incurred to provide services to other federal agencies.

Pre-Filing Taxpayer Assistance and Education
Provides services to taxpayers before returns are filed, to assist taxpayers in preparing correct returns. Primary activities include interpretations, preparing and disseminating tax publications and information, taxpayer education programs, researching customer needs, pre-filing agreements and determinations, and initiatives to promote electronic tax filing. Exchange revenues include user fees from the pre-filing agreements and determinations, letter rulings, and enrolled agent fees.

Filing and Account Services
Performs accounts maintenance functions of processing tax returns, recording tax payments, issuing refunds, and maintaining taxpayer accounts. The scope extends to all tax returns and taxpayer accounts regardless of type and method of filing. Program activities also include providing field assistance in preparing tax returns and supplying tax forms to the public.

Compliance Services
Administers compliance activities after a return is filed in order to identify and correct possible errors or underpayments. This program includes field collection activities, document matching, examination of returns, criminal investigation, and tax litigation. Exchange revenues include installment agreement fees.

Administration of Earned Income Tax Credit (EITC)
Administers the EITC program. It includes expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with EITC. It comprises pre-filing, filing and account services, and compliance activities. EITC payments actually refunded to individuals or credited against other tax liabilities are not included in program costs.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Years Ended September 30, 2001 and 2000

**Statements of Budgetary Resources**
The statements of budgetary resources are presented using the budgetary basis of accounting. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. These financial statements are in addition to the reports prepared by the Service throughout the years pursuant to OMB directives for purposes of monitoring and controlling the Service's obligation and expenditure of budgetary resources.

**Statements of Financing**
The statements of financing are presented using both an accrual and a budgetary basis of accounting as a means to facilitate understanding of the differences between the two accounting bases.

**Statements of Custodial Activity**
The statements of custodial activity are presented on the modified cash basis of accounting. This method initially reports revenue in the financial statements on the cash basis, which is then adjusted by the change in net federal taxes receivable --net of the change in refunds payable-- during the current fiscal year. This adjustment effectively converts the cash basis revenue and refunds to a full accrual amount. The related distribution of all such collections to the Treasury is similarly reported on the cash basis. It is then adjusted to the accrual basis by the net change during the fiscal year in uncollected amounts due to Treasury.

Refunds of taxes and interest are reported on the cash basis. Refunds include payments of earned income tax credits (EITC) and child care credits, as well as overpayments of taxes.

**D. Financing Sources and Exchange Revenue**

The Service receives the majority of its funding through annual, multi-year, and no-year appropriations that are available for use within statutory limits for operating and capital expenditures. Appropriations are recognized as financing sources when the related expenses are incurred. The following are the different types of operating appropriations:

**Processing, Assistance, and Management**
This appropriation provides funds for processing tax returns and related documents; assisting taxpayers in the filing of their returns and in paying taxes that are due; matching information returns with tax returns; conducting internal audit reviews and internal security investigations; and managing financial resources, rent, and utilities.

**Tax Law Enforcement**
The purpose of this appropriation is to provide funds for the examination of tax returns, and the administrative and judicial settlement of taxpayer appeals of examination findings. It also provides for issuing technical rulings, monitoring employee pension plans, determining qualifications of organizations seeking tax-exempt status, examining tax returns of exempt organizations, enforcing statutes relating to detection and investigation of criminal violations of the internal revenue laws, collecting unpaid accounts, compiling statistics of income and compliance research, and securing unfiled tax returns and payments.

**Information Systems**
This appropriation funds costs for data processing and information and telecommunication support for the Service's activities, including developmental information systems and operational information systems. The operational systems are located in a variety of sites including the Martinsburg Computing Center, the Detroit Computing Center, the Tennessee Computing Center, and in district offices and service centers.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Other**
These budgetary accounts consist of an aggregate of smaller multi-functional funds that support the Service's mission to collect the proper amount of tax and provide improved customer service to the taxpayer. The Information Technology Investments appropriation is the largest of these funds and may be obligated as Congress approves expenditure plans. Also included is the Earned Income Tax Credit appropriation that funds the administration of the EITC program.

In addition, the Service incurs certain costs that are paid in total or in part by other federal entities, such as pension costs administered by the Office of Personnel Management and legal judgments paid by the Treasury Judgment Fund. These constitute subsidized costs and are recognized by the Service on its statements of changes in net position and statements of financing as imputed financing sources equal to the cost paid by other federal entities.

**E. Fund Balance with Treasury and Cash**

The fund balance with Treasury is the aggregate amount of funds in the Service's accounts including appropriated funds from which the Service is authorized to make expenditures and pay liabilities; as well as funds in deposit, suspense, and clearing accounts. Generally, cash receipts and disbursements are processed by the Treasury. Imprest funds are maintained by Headquarters and field offices in commercial bank accounts.

**F. Accounts Receivable, Net**

Accounts receivable consists of amounts due from federal agencies, state and local governments, and the public. The balance of accounts receivable for reimbursable services includes both billed and unbilled receivables. Unbilled accounts receivable are recorded, and reimbursable revenues are recognized, as the services are performed and costs are incurred. The unbilled receivables are later transferred to billed accounts receivable when bills are rendered to the buying agencies. The allowance for uncollectible accounts is based on an annual review of groups of accounts by age and includes accounts receivable balances older than one year.

**G. Advances**

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF). Amounts in the fund are available for expenses of operating and maintaining common administrative services of Treasury that can be performed more economically as a centralized service. Centralized services funded through the WCF for the Service consist primarily of telecommunications services, payroll processing, and depreciation of property and equipment owned by the WCF. Each quarter the WCF allocates charges for these services to the Service based on its pro rata share of usage. In accordance with established WCF procedures, Treasury collects funds for these services in advance from Treasury bureaus. The Service records the initial payments as advances and subsequently recognizes expenses as quarterly statements are received.

In FY 1999 the Service recorded a one-time accounting adjustment to capitalize telecommunications equipment owned by the WCF. These costs are included in advances to government agencies as of September 30, 2001 and September 30, 2000, and are amortized over the seven-year life of the equipment. After FY 1999, further capitalization of WCF equipment was discontinued. Subsequently, all WCF costs--including depreciation of equipment—are reported as current year expenses.

The majority of advances to the public are for investigations and employee travel advances, which are expensed upon receipt of employees' expense reports.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

### H. Property and Equipment

The net book values of Property and Equipment as of September 30, 2001 and 2000, consist of the following components:

**General Property and Equipment acquired before October 1, 1999**
The estimated net book value of ADP equipment, telecommunication equipment, office equipment and furniture, investigative equipment, and vehicles as of September 30, 1999, was derived based upon estimates of the net book value of a statistically selected sample of assets, using techniques prescribed by the Uniform Standards of Appraisal Practice. These estimated net book values were then projected to the entire population of assets. With the exception of small expendable computer peripherals such as keyboards and cables, all property and equipment in the categories described above and acquired before October 1, 1999 is capitalized regardless of the dollar amount of individual assets. Depreciation on these assets is calculated using the straight line method and is based on the estimated net book values and projected remaining useful lives of the assets as of September 30, 1999.

**ADP and Telecommunication Equipment acquired after September 30, 1999**
The method used by the Service to report the capitalized ADP and telecommunication assets acquired after September 30, 1999 is described as "pooling." Under pooling, all ADP and telecommunication equipment is recorded at cost. Each fiscal year separate pools are established for each class of ADP and telecommunication assets, as distinguished by the useful lives of the assets. In FY 2001 and FY 2000, there are two pools--one for equipment with a useful life of three years, consisting of microcomputers, related equipment, and software; the other for assets with a useful life of seven years, consisting of supercomputers, mainframes, minicomputers, telecommunications equipment, and all related equipment and software. Beginning in fiscal year 2001, software is excluded from ADP and telecommunications equipment if it is associated with one of the major internal use software projects described below under **Internal Use Software**. Small computer peripherals are excluded from the pools. With these exceptions, all other costs of ADP and telecommunication equipment acquired after September 30, 1999 are accumulated regardless of the dollar value of individual assets.

Depreciation on these assets is calculated using the straight-line method over the estimated useful lives with a half-year of depreciation taken in the year of acquisition. Under the pooling concept, only disposals that are material to the financial statements are recognized. The Service performed an analysis of the FY 2001 and 2000 pools and determined that disposals were not material to the financial statements.

**Office Equipment and Furniture, Investigative Equipment, and Vehicles acquired after September 30, 1999**
The Service capitalizes office equipment and furniture, investigative equipment, and Criminal Investigation Division vehicles acquired after September 30, 1999, with an individual-asset acquisition cost of $5,000 or more. Depreciation on these assets is calculated using the straight-line method over the estimated useful lives with a half-year of depreciation taken in the year of acquisition. Useful lives are established as ten years for office equipment and investigative equipment, eight years for furniture, and five years for vehicles. Under the pooling concept, only disposals that are material to the financial statements are recognized. The Service performed an analysis of the FY 2001 and 2000 pools and determined that disposals were not material to the financial statements.

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Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Years Ended September 30, 2001 and 2000

**Major Systems**
The Service has ten systems it considers major systems as of September 30, 2001 and September 30, 2000. Major systems are defined as any system where the estimated development costs are expected to exceed $20 million. Costs included in the major systems category include direct operating costs for the design, development, acquisition, and implementation of the major systems software. Other costs associated with these major systems, such as hardware, transportation and installation of hardware are included in the property and equipment categories previously described. Costs associated with preparation of facilities to house the systems are classified as leasehold improvements.

Prior to FY 2001 the Service capitalized certain costs of large-scale computer systems as major systems. Due to implementation of Statement of Federal Financial Accounting Standards No. 10, *Accounting for Internal Use Software*, the Service discontinued accumulation of costs in the major systems category after September 30, 2000. Subsequently, such costs are included in internal use software. Costs capitalized prior to September 30, 2000 continue to be depreciated over the remaining useful lives of the major systems.

Separate categories are established for major systems and major systems in process. Major systems are considered placed in service when development is complete; the system is in all-important respects ready for use, deployment of the system is underway, and significant system changes are not anticipated. Until placed in service, major systems are shown as work in process (WIP). Major systems are depreciated using the straight-line method over an estimated useful life of seven years with a half-year of depreciation taken in the year the major system is placed in service. Major systems are disposed—or net book value is reduced—to the extent they are considered impaired. During the years ended September 30, 2001 and September 30, 2000 there were no disposals of assets included in major systems.

**Internal Use Software**
In accordance with Statement of Federal Financial Accounting Standards No. 10, *Accounting for Internal Use Software*, beginning in FY 2001, the Service capitalizes all internal use software with an acquisition or estimated development cost of $7 million or more.

Capitalized costs for internally or contractor-developed internal use software include the full costs, both direct and indirect, incurred during the software development stage. As such, capitalizable costs are limited to costs incurred after:

- Management authorizes and commits to a computer software project, believes that it is more likely than not that the project will be completed, and expects the software will be used to perform the intended function with an estimated service life of two years or more and;
- Completion of the preliminary design stage—i.e., conceptual formulation, design, and testing of possible software project alternatives.

Internal-use software is considered work in process until final acceptance and testing have been successfully completed. Once completed, the costs are amortized using the straight-line method over the estimated useful life of seven years with a half-year of amortization taken in the year placed in service. Internal use software projects are disposed—or net book value is reduced—to the extent they are considered impaired. During the year ended September 30, 2001 there were no disposals of amounts included in internal use software.

**Leasehold Improvements**
This category of assets is shown at historical cost less depreciation. Depreciation on these assets is calculated using the straight-line method with ten years as the estimated useful life of the improvements with a half-year of depreciation taken in the year of acquisition. For projects initiated before October 1, 1999, a $50,000 threshold was used to identify projects capitalized as leasehold improvements; all leasehold improvement projects initiated after September 30, 1999 are capitalized regardless of cost.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**I. Capital Lease Liability**

Certain computer equipment, mail sorters, copiers and other equipment are leased under Lease-To-Ownership-Plans (LTOP). The original terms of these LTOPs provide for 36 monthly payments for computers, and from 36 to 60 months for other equipment. Under each LTOP, the equipment is owned as of the last monthly payment. These LTOP leases are classified as capital leases. The liability reported represents the lesser of the net present value of future lease payments required by the terms of the capital leases or fair market value. Beginning in fiscal 2001, the capital lease liability for computers and other equipment is included in funded liabilities. Prior to fiscal 2001, the liability is included in Liabilities Not Covered by Budgetary Resources.

In fiscal year 2001, the Service exercised its option to purchase computer equipment related to the Mainframe Consolidation Project and retired all remaining capital lease liabilities on this equipment.

Beginning in fiscal year 2001, due to the implementation of Statement of Federal Financial Accounting Standards No. 10, *Accounting for Internal Use Software*, capital lease liability also includes amounts for computer software leased under software licensing agreements. These licensing agreements provide for payments over periods ranging from three to six years. The liability reported represents the net present value of future lease payments. The capital lease liability for software licenses is included in Liabilities Not Covered by Budgetary Resources.

**J. Permanent and Indefinite Funds**

The Service uses a special class of funds, designated as "permanent and indefinite," to disburse tax refund principal and related interest. These permanent and indefinite funds are not subject to budgetary ceilings set by Congress during the annual appropriation process. Because Congress permanently funds tax refunds from a budgetary standpoint, tax refunds payable at year-end are fully funded. The asset "Due from Treasury" designates this approved funding to pay year-end tax refund liabilities, which are reflected in the funds used for refund of federal taxes on the statement of custodial activity along with tax refund payments for the year.

Although funded through the appropriation process, refund activity is reported as a custodial activity of the Service. This presentation is appropriate because refunds are, in substance, a custodial revenue-related activity in that they are a direct result of taxpayer overpayments of their tax liabilities. Federal tax revenue received from taxpayers is not available for use in the operation of the Service and is not reported on the statements of net cost. Likewise, the resultant refunds of overpayments are not available for use by the Service in operations. Consequently, to present refunds as an expense of the Service on the statements of net cost with related appropriations used would be inconsistent with the reporting of the related federal tax revenue and would materially distort the costs incurred by the Service in meeting its strategic objectives.

**K. Tax Assessments and Abatements**

Under the Internal Revenue Code Section 6201, the Commissioner of the IRS, as delegated by the Secretary of the Treasury, is authorized and required to make inquiries, determinations, and assessments of all taxes that have been imposed and accruing under any internal revenue law but have not been duly paid (including interest, additions to the tax, and assessable penalties). Unpaid assessments result from taxpayers filing returns without sufficient payments; as well as from the Service's enforcement programs, such as examination, under-reporter, substitute for return, and combined annual wage reporting.

The Commissioner of the IRS also has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process (Abatements may be allowed for a qualifying corporation that claimed a net operating loss that created a credit that can be carried back to reduce a prior year's tax liability, amended tax returns, correction of an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise, penalty abatements for reasonable cause, contested assessments made due to mathematical or clerical errors, and assessments contested after the liability has been satisfied). Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

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Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Years Ended September 30, 2001 and 2000

**L. Federal Taxes Receivable**

Federal taxes receivable and the corresponding liability, “Due to Treasury,” are not accrued until related tax returns are filed, or assessments made, and prepayments netted against liabilities. Accruals are made to reflect penalties and interest on taxes receivable through the balance sheet date.

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers for which the Service can support the existence of a receivable through taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the Service. Taxes receivable are shown on the balance sheet net of an allowance for doubtful accounts. The allowance for doubtful accounts reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Compliance assessments are unpaid assessments, for which neither the taxpayer nor a court has affirmed that the taxpayer owes amounts to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. These amounts are not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Write-offs consist of unpaid assessments for which the Service does not expect further collections due to factors such as taxpayers’ bankruptcy, insolvency, or death. These amounts are also not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

**M. Significant Change in Accounting Principles**

**Internal Use Software -** In accordance with the requirements of Statement of Federal Financial Accounting Standards No. 10, *Accounting for Internal Use Software*, costs incurred after September 30, 2000, for the acquisition or development of internal-use software are capitalized. In accordance with the Standard, the new accounting principle is adopted prospectively. Amounts capitalized or expensed in fiscal years prior to FY 2001 have not been restated.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 2. Fund Balance with Treasury and Cash**
*(In Millions)*

Fund balance with Treasury and cash as of September 30, 2001 and 2000, consist of the following:

| Fund Balances and Cash | 2001 | 2000 |
|---|---|---|
| Appropriated and other funds | $ 2,067 | $ 2,005 |
| Imprest funds | 3 | 3 |
| **Fund Balance with Treasury and Cash** | $ 2,070 | $ 2,008 |

| Status of Fund Balance with Treasury | 2001 | 2000 |
|---|---|---|
| Unobligated balances | | |
| - Available | $ 196 | $ 346 |
| - Unavailable | 245 | 445 |
| Obligated balances not yet disbursed | 1,635 | 1,232 |
| Other funds | (9) | (18) |
| **Fund Balance with Treasury** | $ 2,067 | $ 2,005 |

Available unobligated balances represent no-year and multi-year appropriations that can be obligated after September 30, 2001 and September 30, 2000. Unavailable unobligated balances are expired appropriations no longer available to incur new obligations. Obligated balances not yet disbursed include undelivered orders of $938 million and $614 million as of September 30, 2001 and 2000, respectively. Other funds primarily consist of suspense, deposit, and clearing funds.

In FY 2001and FY 2000, the $1,379 and $1,405 totals of unobligated balances and undelivered orders are different than the $1,380 and $1,385 balances of unexpended appropriations, respectively. These differences result from user fees and receivables with the public. User fees that have not yet been transferred to appropriations are included in fund balance but do not represent unexpended appropriations. Receivables from the public are included in unexpended appropriations but not in fund balance.

The Information Technology Investments (ITI) fund represents $270 million and $430 million of the appropriated fund balance as of September 30, 2001 and 2000, respectively, which can only be obligated pursuant to an expenditure plan approved by Congress. As of September 30, 2001, Congress has approved a cumulative amount of $577 million in ITI appropriations received, of which $499 million has been obligated. Unobligated balances include $78 million and $305 million of the ITI fund as of September 30, 2001 and 2000, respectively. As of September 30, 2001, the entire $78 million was available for expenditure. As of September 30, 2000, $211 million was available for expenditure, and $94 million was unavailable.

**Note 3. Accounts Receivable, Net**
*(In Millions)*

Accounts receivable and allowances for uncollectible accounts as of September 30, 2001 and 2000, consist of the following:

| | 2001 | | 2000 | |
|---|---|---|---|---|
| | Intra-Governmental | With the Public | Intra – Governmental | With the Public |
| Accounts receivable | $ 35 | $ 5 | $ 19 | $ 6 |
| Allowance for uncollectible accounts | (2) | (2) | (8) | (2) |
| **Accounts Receivable, Net** | $ 33 | $ 3 | $ 11 | $ 4 |

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 4.**
**Other Assets**
*(In Millions)*

Other assets, as of September 30, 2001 and 2000, consist of the following:

| | 2001 | | 2000 | |
|---|---|---|---|---|
| | **Intra-Governmental** | **With the Public** | **Intra-Governmental** | **With the Public** |
| Other custodial assets | $ - | $ 191 | $ - | $ 87 |
| Federal tax lien revolving fund | - | 4 | - | 6 |
| **Total, Other Assets** | $ - | $ 195 | $ - | $ 93 |

Other custodial assets primarily represent voluntary deposits received from taxpayers, pending application of the funds to unpaid tax assessments. This category also includes seized monies of $2 million and $3 million as of September 30, 2001 and 2000, respectively, which are held pending the results of criminal investigations. As described in Note 12, other custodial assets are classified as "Non-Entity Assets" and are offset by an equal liability in other custodial liabilities.

The Federal tax lien revolving fund primarily consists of real property held for resale to the public. In accordance with Section 7425 of the Internal Revenue Code and Section 2410 of Title 28, the revolving fund can be used to redeem real property foreclosed upon by a holder of a lien, which is superior to the tax lien. Real property is redeemed when the Service pays the lien holder the amount bid at sale plus interest and certain post-sale expenses. The Service may then sell the property, reimburse the fund, and apply the net proceeds to the outstanding tax obligation.

**Note 5.**
**Federal Taxes Receivable, Net**

Federal taxes receivable (gross) was $80 billion and $81 billion as of September 30, 2001 and 2000, respectively, and consisted of tax assessments, penalties, and interest that were not paid or abated, and which were agreed to by the taxpayer and the Service, or upheld by the courts.

Federal taxes receivable (net) equaled $20 billion and $22 billion as of September 30, 2001 and 2000, respectively, and is the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of $60 billion and $59 billion was established in FY 2001 and FY 2000, respectively, for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

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**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 6. Property and Equipment**
*(In Millions)*

Property and equipment as of September 30, 2001 and 2000 consist of the following:

| Category | Useful Life | Net Book Value/ Cost | Accumulated Depreciation | Net Book Value 9/30/2001 | Net Book Value 9/30/2000 |
|---|---|---|---|---|---|
| ADP assets | 3 to 7 Years | $ 1,172 | $ (491) | $ 681 | $ 584 |
| Furniture and non-ADP equipment | 8 to 10 Years | 56 | (14) | 42 | 47 |
| Investigative equipment | 10 Years | 11 | (4) | 7 | 9 |
| Vehicles | 5 Years | 68 | (37) | 31 | 39 |
| | | 1,307 | (546) | 761 | 679 |
| Major systems | 7 Years | 423 | (92) | 331 | 361 |
| Major systems – work in process | | - | - | - | 28 |
| Internal use software | 7 Years | 26 | (2) | 24 | - |
| Internal use software – work in process | | 52 | - | 52 | - |
| Leasehold improvements | 10 Years | 287 | (74) | 213 | 197 |
| Construction in progress | | - | - | - | 1 |
| **Total Property and Equipment** | | **$ 2,095** | **$ (714)** | **$ 1,381** | **$ 1,266** |

The Net Book Value/Cost column for property and equipment represents the combination of (1) net book value of certain property and equipment acquired before October 1, 1999, derived from estimates, as discussed in Note 1; and (2) the actual cost of other property and equipment.

The net book value of property and equipment derived from estimates--item (1) above-- consists of the following:

| Category | Useful Life | Net Book Value | Accumulated Depreciation | Net Book Value 9/30/2001 | Net Book Value 9/30/2000 |
|---|---|---|---|---|---|
| ADP assets | 3 to 7 Years | $ 668 | $ (405) | $ 263 | $ 413 |
| Furniture and non-ADP equipment | 8 to 10 Years | 16 | (5) | 11 | 13 |
| Investigative equipment | 10 Years | 11 | (4) | 7 | 9 |
| Vehicles | 5 Years | 48 | (33) | 15 | 31 |
| **Total Property and Equipment** | | **$ 743** | **$ (447)** | **$ 296** | **$ 466** |

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**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 6. Property and Equipment** *(In Millions)* (Continued)

Property and equipment acquired through capital leases are included in the categories below. Disclosures concerning associated capital lease liabilities are provided in Note 9.

| Category | Useful Life | Cost | Accumulated Depreciation | Net Book Value 9/30/2001 | Net Book Value 9/30/2000 |
|---|---|---|---|---|---|
| ADP assets | | | | | |
| Mainframe consolidation | 7 Years | $ 80 | $ (28) | $ 52 | $ 63 |
| ADP Equipment | 7 years | 7 | - | 7 | - |
| Software licenses | 3 to 7 Years | 125 | (17) | 108 | - |
| | | $ 212 | $ (45) | $ 167 | $ 63 |
| Furniture and Non-ADP Equipment | | | | | |
| Mail sorters | 10 Years | 19 | (5) | 14 | 16 |
| Photocopiers | 10 Years | 4 | (1) | 3 | 3 |
| | | 23 | (6) | 17 | 19 |
| **Totals** | | **$ 235** | **$ (51)** | **$ 184** | **$ 82** |

**Note 7. Accounts Payable and Accrued Expenses** *(In Millions)*

Accounts payable and accrued expenses as of September 30, 2001 and 2000, consist of the following:

| | 2001 | | 2000 | |
|---|---|---|---|---|
| | Intra-Governmental | With the Public | Intra-Governmental | With the Public |
| Accounts payable | $ - | $ 27 | $ - | $ 43 |
| Accrued expenses | 43 | 301 | 30 | 233 |
| Accrued payroll and benefits | 46 | 307 | 41 | 280 |
| **Total Accounts Payable and Accrued Expenses** | $ 89 | $ 635 | $ 71 | $ 556 |

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**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 8. Other Liabilities** *(In Millions)*

Other liabilities as of September 30, 2001 and 2000, consist of the following:

| | 2001 | | 2000 | |
|---|---|---|---|---|
| | **Intra-Governmental** | **With the Public** | **Intra-Governmental** | **With the Public** |
| Workers' compensation | $ 85 | $ 513 | $ 82 | $ 440 |
| Accrued annual leave | - | 367 | - | 382 |
| Suspense | (4) | - | 5 | - |
| Other custodial liabilities | - | 191 | - | 87 |
| **Total Other Liabilities** | $ 81 | $ 1,071 | $ 87 | $ 909 |

Workers' compensation is paid to employees injured on the job or incurring work-related illnesses, as required by the Federal Employees Compensation Act (Act). The Act provides income, medical cost protection, and death benefits to covered federal civilian employees and their beneficiaries. The program is administered by the U.S. Department of Labor, which initially pays valid claims and subsequently seeks reimbursement from federal agencies. The liability of $598 million at September 30, 2001 includes a current portion of $85 million and estimated future costs of $513 million. As of September 30, 2000, the liability of $522 million includes a current portion of $82 million and estimated future costs of $440 million. Estimated future costs have been actuarially determined, and are regarded as a liability to the public because neither the costs nor reimbursement have been recognized by the Department of Labor. Workers' Compensation is included in Liabilities Not Covered by Budgetary Resources, as described in Note 13.

Accrued annual leave consists of employees' unpaid leave balances at September 30, 2001 and 2000, and reflects wage rates in effect at fiscal year end. Accrued annual leave is included in Liabilities Not Covered by Budgetary Resources, as described in Note 13.

Other custodial liabilities (the offsetting liability to other custodial assets) primarily consist of liabilities to taxpayers for deposits pending application of the funds to outstanding tax deficiencies and liability for seized monies.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 9.**
**Leases**
*(In Millions)*

The capital lease liability as of September 30, 2001, is as follows:

| | Total | 2002 | 2003 | 2004 | 2005 and Beyond |
|---|---|---|---|---|---|
| Mainframe consolidation | $ - | $ - | $ - | $ - | $ - |
| Mail sorters | 11 | 6 | 5 | - | - |
| Copiers and other | 10 | 4 | 3 | 3 | - |
| Software licenses | 124 | 39 | 40 | 33 | 12 |
| **Total Lease Obligations** | $ 145 | $ 49 | $ 48 | $ 36 | $ 12 |
| Less: Interest | (20) | | | | |
| **Present Value of Lease Payments** | $ 125 | | | | |

The capital lease liability as of September 30, 2000, is as follows:

| | Total | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| Mainframe consolidation | $ 14 | $ 13 | $ 1 | $ - |
| Mail sorters | 10 | 4 | 4 | 2 |
| Copiers and other | 2 | 1 | 1 | - |
| **Total Lease Obligations** | $ 26 | $ 18 | $ 6 | $ 2 |
| Less: Interest | (5) | | | |
| **Present Value of Lease Payments** | $ 21 | | | |

In fiscal years 2001 and 2000, certain computer equipment related to the Mainframe Consolidation Project, mail sorters, copiers and other equipment is leased under Lease-To-Ownership-Plans. The original terms of these LTOPs provide for 36 monthly payments for computers, and from 36 to 60 monthly payments for other equipment. Under each LTOP, the equipment is owned as of the last monthly payment. Interest rates range from 5 to 11 percent.

In fiscal year 2001, the Service exercised its option to purchase computer equipment related to the Mainframe Consolidation Project and retired all remaining capital lease liabilities on this equipment.

Beginning in fiscal year 2001, new capital lease liabilities for copiers and other equipment are included in funded liabilities. Prior to fiscal year 2001, capital lease liabilities for copiers and equipment are included in Liabilities Not Covered by Budgetary Resources. As of September 30, 2001, this resulted in $10 million in funded liabilities and $115 million in Liabilities Not Covered by Budgetary Resources.

Beginning in fiscal year 2001, capital lease treatment is accorded to computer software leased under software licensing agreements. These licensing agreements provide for payments over periods ranging from three to six years. The liability reported represents the net present value of future lease payments, and is included in Liabilities Not Covered by Budgetary Resources. The effect of applying capital lease treatment to software licenses in FY2001 is to 1) capitalize software licenses of $ 125 million, 2) recognize current depreciation/amortization of $17 million, and 3) reduce monthly lease payments included in operating expenses by $24 million, resulting in an overall reduction of net cost of $7 million.

The Service leases office space, vehicles and equipment under annual operating leases. These leases are cancelable or renewable on an annual basis at the option of the Service. They do not impose binding commitments on the Service for future rental payments on leases with terms longer than one year.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 10. Contingencies**

As of September 30, 2001 and 2000, the Service provided an accrual for contingent losses of $6 million and $12 million, respectively, for pending and threatened legal matters that, in the opinion of Chief Counsel, are considered probable. No additional losses are considered probable by Chief Counsel. Of these amounts, certain settlements and awards may be payable from the Treasury Judgment Fund in accordance with 31 U.S.C. 1304. For fiscal year 2001, of the $6 million accrued by the Service, $6 million is estimated to be payable from the Treasury Judgment Fund for settlements and awards relating to these claims. For fiscal year 2000, of the $12 million accrued by the Service, all was estimated to be payable from the Treasury Judgment Fund for settlements and awards relating to those claims.

The Service does not have contractual commitments for payments on obligations related to canceled appropriations.

**Note 11. Reobligation of Funds**

Obligations incurred in fiscal years 2001 and 2000 include upward adjustments of obligations established in earlier fiscal years of $153 million and $26 million, respectively. In part, the increase in upward adjustments in FY 2001 resulted from reobligation of amounts deobligated in FY 2000. During FY 2000, undelivered orders were deobligated based on a review of open obligations. In FY 2001, based on additional information, the Service reobligated a portion of the deobligated orders. Reobligations account for $76 million of the total upward adjustments of $153 million in FY 2001, and $5 million of total upward adjustments of $26 million in FY 2000.

**Note 12. Non-entity Assets** (*In Millions*)

Non-entity assets arise from the Service's custodial duty to collect taxes, disburse tax refunds and maintain proper accounting for these activities in the books and records of the Service. Non-entity assets as of September 30, 2001 and 2000, consist of the following:

| | **2001** | | **2000** | |
|---|---|---|---|---|
| | **Intra-Governmental** | **With the Public** | **Intra-Governmental** | **With the Public** |
| Due from Treasury | $ 1,419 | $ - | $ 1,040 | $ - |
| Federal taxes receivable, net of Allowance for doubtful accounts | - | 20,000 | - | 22,000 |
| Other custodial assets | - | 191 | - | 87 |

Due from Treasury represents tax refunds due to taxpayers but not disbursed as of September 30, 2001 and 2000.

Federal taxes receivable are transferred to Treasury upon receipt. An amount equal to federal taxes receivable has been recognized as an offsetting intragovernmental liability – Due to Treasury. Federal taxes receivable is described in more detail in Note 5.

Other custodial assets, also discussed in Note 4, primarily relate to the deposits received from taxpayers, pending application of the funds to unpaid tax assessments and seized monies.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 13. Liabilities Not Covered by Budgetary Resources** *(In Millions)*

Liabilities not covered by budgetary resources as of September 30, 2001 and 2000, consist of the following:

| | 2001 | | 2000 | |
|---|---|---|---|---|
| | **Intra-Governmental** | **With the Public** | **Intra-Governmental** | **With the Public** |
| Workers' compensation | $ 85 | $ 513 | $ 82 | $ 440 |
| Accrued annual leave | - | 367 | - | 382 |
| Contingencies | - | 6 | - | 12 |
| Capital lease liability | - | 115 | - | 21 |

Liabilities not covered by budgetary resources are liabilities that are not funded by direct budgetary authority and result from the receipt of goods and services, or the occurrence of eligible events, for which appropriations, revenues, or other financing sources necessary to pay the liabilities have not yet been made available through Congressional appropriation. See Note 8 for further description of workers' compensation and accrued annual leave, Note 9 for capital lease liability and Note 10 for contingencies.

**Note 14. Comparison of Statement of Budgetary Resources and the President's Budget** *(In Millions)*

Balances reported in the Statement of Budgetary Resources and the President's Budget are shown in the table below for each of the major appropriations, the Information Technology Investment Account, and the Earned Income Tax Credit appropriation. The table excludes other minor appropriations.

There are significant differences between the Statement of Budgetary Resources and the President's Budget that are attributable to differing requirements imposed by Treasury and OMB. The differences are due to reporting requirement differences between the Treasury guidance used to prepare the Statement of Budgetary Resources and the OMB guidance used to prepare the President's Budget. For example, the President's Budget includes full funding for retiree costs, which are excluded from the Statement of Budgetary Resources. Additionally, the differences are attributable to the fact that budgetary information is submitted for the President's Budget prior to completion of most agency audits (timing differences) causing audit adjustments not to be reflected in the President's Budget balances. Balances on the Unobligated – unavailable line of the President's Budget included in the Service's FY 2000 financial statements have been restated as unobligated – available in order to comply with OMB guidance.

| | FY 2001 | | FY 2000 | |
|---|---|---|---|---|
| | **Statement of Budgetary Resources** | **President's Budget** | **Statement of Budgetary Resources** | **President's Budget** |
| **Processing Assistance and Management:** | | | | |
| Budgetary Resources | | | | |
| Budget authority | $ 3,755 | $ 3,914 | $ 3,376 | $ 3,380 |
| Unobligated balances – beg. of period | 168 | 20 | 143 | 13 |
| Spending authority from offsetting Collections | 27 | 32 | 28 | 27 |
| Adjustments | 24 | 21 | (22) | (32) |
| Total Budgetary Resources | 3,974 | 3,987 | 3,525 | 3,388 |
| Status of Budgetary Resources | | | | |
| Obligations incurred | 3,800 | 3,934 | 3,357 | 3,360 |
| Unobligated balances – available | 58 | 53 | 20 | 28 |
| Unobligated balances – unavailable | 116 | - | 148 | - |
| Total Status of Budgetary Resources | 3,974 | 3,987 | 3,525 | 3,388 |
| Outlays | $ 3,560 | $ 3,719 | $ 3,318 | $ 3,324 |

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**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 14. Comparison of Statement of Budgetary Resources and Submission to President's Budget**
*(In Millions)*

(Continued)

| | FY 2001 | | FY 2000 | |
|---|---|---|---|---|
| | **Statement of Budgetary Resources** | **President's Budget** | **Statement of Budgetary Resources** | **President's Budget** |
| **Tax Law Enforcement:** | | | | |
| Budgetary Resources | | | | |
| Budget authority | $ 3,450 | $ 3,673 | $ 3,283 | $ 3,285 |
| Unobligated balances – beg. of period | 90 | - | 76 | - |
| Spending authority from offsetting Collections | 80 | 101 | 61 | 62 |
| Adjustments | (7) | 5 | - | - |
| Total Budgetary Resources | 3,613 | 3,779 | 3,420 | 3,347 |
| Status of Budgetary Resources | | | | |
| Obligations incurred | 3,548 | 3,753 | 3,330 | 3,342 |
| Unobligated balances – available | 13 | 26 | - | 5 |
| Unobligated balances – unavailable | 52 | - | 90 | - |
| Total Status of Budgetary Resources | 3,613 | 3,779 | 3,420 | 3,347 |
| Outlays | $ 3,437 | $ 3,660 | $ 3,205 | $ 3,204 |
| **Information Systems:** | | | | |
| Budgetary Resources | | | | |
| Budget authority | $ 1,608 | $ 1,649 | $ 1,502 | $ 1,502 |
| Unobligated balances – beg. of period | 187 | 53 | 209 | 22 |
| Spending authority from offsetting Collections | 3 | 6 | 12 | 9 |
| Adjustments | (6) | 106 | 9 | 71 |
| Total Budgetary Resources | 1,792 | 1,814 | 1,732 | 1,604 |
| Status of Budgetary Resources | | | | |
| Obligations incurred | 1,700 | 1,774 | 1,545 | 1,544 |
| Unobligated balances – available | 27 | 40 | 90 | 60 |
| Unobligated balances – unavailable | 65 | - | 97 | - |
| Total Status of Budgetary Resources | 1,792 | 1,814 | 1,732 | 1,604 |
| Outlays | $ 1,501 | $ 1,540 | $ 1,649 | $ 1,649 |

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**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 14. Comparison of Statement of Budgetary Resources and Submission to President's Budget**
*(In Millions)*

(Continued)

| | FY 2001 | | FY 2000 | |
|---|---|---|---|---|
| | **Statement of Budgetary Resources** | **President's Budget** | **Statement of Budgetary Resources** | **President's Budget** |
| **Information Technology Investment Account:** | | | | |
| Budgetary Resources | | | | |
| Budget authority | $ 165 | $ 166 | $ - | $ - |
| Unobligated balances – beg. of period | 305 | 211 | 481 | 480 |
| Spending authority from offsetting Collections | - | - | - | - |
| Adjustments | (91) | - | - | - |
| Total Budgetary Resources | 379 | 377 | 481 | 480 |
| Status of Budgetary Resources | | | | |
| Obligations incurred | 301 | 299 | 176 | 176 |
| Unobligated balances – available | 78 | 78 | 211 | 304 |
| Unobligated balances – unavailable | - | - | 94 | - |
| Total Status of Budgetary Resources | 379 | 377 | 481 | 480 |
| Outlays | $ 231 | $ 231 | $ 76 | $ 76 |
| **Earned Income Tax Credit:** | | | | |
| Budgetary Resources | | | | |
| Budget authority | $ 145 | $ 152 | $ 144 | $ 144 |
| Unobligated balances – beg. of period | 16 | - | 12 | - |
| Spending authority from offsetting Collections | - | - | - | - |
| Adjustments | (1) | - | (1) | - |
| Total Budgetary Resources | 160 | 152 | 155 | 144 |
| Status of Budgetary Resources | | | | |
| Obligations incurred | 144 | 149 | 139 | 140 |
| Unobligated balances – available | 3 | 3 | 5 | 4 |
| Unobligated balances – unavailable | 13 | - | 11 | - |
| Total Status of Budgetary Resources | 160 | 152 | 155 | 144 |
| Outlays | $ 146 | $ 153 | $ 135 | $ 135 |

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**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 15. Collections of Federal Tax Revenue** *(In Billions)*

The Service transfers total tax collections to the U.S. Treasury. Collection activity, by financial statement line item and tax year, was as follows for the fiscal year ended September 30, 2001 and 2000:

| | Tax Year 2001 | Tax Year 2000 | Tax Year 1999 | Tax Year Prior Years | Collections Received FY 2001 | Collections Received FY 2000 |
|---|---|---|---|---|---|---|
| Individual income, FICA/SECA, and other | $ 1,155* | $ 666 | $ 14 | $ 9 | $ 1,844 | $ 1,765 |
| Corporate income | 99** | 80 | 1 | 7 | 187 | 235 |
| Excise | 37 | 15 | - | - | 52 | 55 |
| Estate and gift | 1 | 25 | 1 | 2 | 29 | 29 |
| Railroad retirement | 4 | 1 | - | - | 5 | 5 |
| Federal unemployment | 5 | 2 | - | - | 7 | 7 |
| **Total** | $ 1,301 | $ 789 | $ 16 | $ 18 | $ 2,124 | $ 2,096 |
| | 61% | 37% | 1% | 1% | 100% | |

* Includes other collections of $395 million.
** Includes tax year 2002 corporate income tax receipts of $5 billion.

In FY 2001, Individual income, FICA/SECA, and other taxes include $56 billion in payroll taxes collected from other federal agencies. Of this amount, $12 billion represents the portion paid by the employers.

**Note 16. Federal Tax Refund Activity** *(In Billions)*

Refund activity, broken out similarly to collection activity by tax year, was as follows for the fiscal years ended September 30, 2001 and 2000:

| | Tax Year 2001 | Tax Year 2000 | Tax Year 1999 | Tax Year Prior Years | Refunds Disbursed FY 2001 | Refunds Disbursed FY 2000 |
|---|---|---|---|---|---|---|
| Individual income, FICA/SECA, and other | $ 2 | $ 196 | $ 9 | $ 4 | $ 211 | $ 161 |
| Corporate income | 1 | 15 | 8 | 14 | 38 | 31 |
| Excise | - | 1 | - | - | 1 | 1 |
| Estate and gift | - | - | 1 | - | 1 | 1 |
| Railroad retirement | - | - | - | - | - | - |
| Federal unemployment | - | - | - | - | - | - |
| **Total** | $ 3 | $ 212 | $ 18 | $ 18 | $ 251 | $ 194 |
| | 1% | 85% | 7% | 7% | 100% | |

Individual income, FICA/SECA, and other refund amounts include EITC and child tax credit refunds.

In FY 2001, Refunds Disbursed includes $36 billion in special tax rebates, as required by the Economic Growth and Tax Relief Reconciliation Act (Public Law 107-16), effective for tax year 2001.

**Internal Revenue Service**
**Notes to the Financial Statements**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Note 17.**
**Budget Functional Classification**
*(In Millions)*

**Budget Functional Classification**

Gross cost and earned revenue for the Service are classified under the budget functional classification of General Government under the President's budget. Gross cost and earned revenue are categorized as follows:

| | Intragovernmental | With the Public | Total |
|---|---|---|---|
| Gross Cost | $ 2,161 | $ 7,373 | $ 9,534 |
| Earned Revenue | (109) | (127) | (236) |
| Net Cost | **$ 2,052** | **$ 7,246** | **$ 9,298** |

**Note 18.**
**Budgetary Rescissions**

Adjustments in the Budgetary Resources section of the Statement of Budgetary Resources comprise rescissions of budget authority, canceled appropriations, transfers, and recoveries of prior year obligations. In FY 2001, Congress rescinded $131 million of the Service's appropriations. Rescissions include $19 million under Public Law 106-554, $18 million under Public Law 107-20, and $94 million under Public Law 106-246. Public Law 106-246 rescinded $94 million from the FY 1998 Information Technology Investment appropriation and re-appropriated it to the FY 2001 Information Technology Investment appropriation. In FY 2000, Congress rescinded $32 million of the Service's appropriations under Public Law 106-113.

# Supplemental and Other Accompanying Information

**Internal Revenue Service**
**Supplemental Information - Unaudited**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Other Claims for Refund**

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. In FY 2001, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $7.7 billion and by Appeals is $13.6 billion. In FY 2000, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $8.4 billion and by Appeals is $13.5 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheet or for disclosure in the notes to the financial statements. However, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

**Federal Taxes Receivable, Net**
*(In Billions)*

In accordance with SFFAS No. 7, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1 to the financial statements. Although compliance assessments and write-offs are not considered receivables under federal accounting standards, they represent legally enforceable claims of the IRS - acting on behalf of the federal government. There is, however, a significant difference in the collection potential of these categories.

The components of the total unpaid assessments and derivation of net federal taxes receivable at September 30, 2001 and 2000 were as follows:

| | 2001 | 2000 |
|---|---|---|
| Total unpaid assessments | $ 239 | $ 240 |
| Less: Compliance assessments | (22) | (30) |
| Write-offs | (137) | (129) |
| Gross Federal Taxes Receivable | 80 | 81 |
| Less: Allowance for doubtful accounts | (60) | (59) |
| **Federal Taxes Receivable, Net** | $ 20 | $ 22 |

The Service cannot reasonably estimate the amount of allowance for doubtful accounts pertaining to its compliance assessments, and thus cannot determine their net realizable value or the value of the pre-assessment work-in-process.

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $14 billion and $14 billion as of September 30, 2001 and 2000, respectively, assessed against officers and directors of businesses who were involved in the non remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

**Earned Income Tax Credit**

The EITC was originally authorized by the Tax Reduction Act of 1975 (Public Law 94-12) and made permanent by the Revenue Act of 1978 (Public Law 95-600). The EITC is a special credit for taxpayers who work and whose earnings fall below the established allowance ceiling. Qualified taxpayers can receive partial credit in advance in each paycheck. In fiscal year 2001, the Service issued $26.1 billion in EITC refunds, of which $72 million was applied to advance EITC. In fiscal year 2000, the Service issued $26.1 billion in EITC refunds, of which $81.0 million was applied to advance EITC. An additional $5.1 billion and $5.1 billion of the EITC was applied to reduce taxpayer liability for fiscal years 2001 and 2000, respectively.

Internal Revenue Service
Supplemental Information - Unaudited
For the Fiscal Years Ended September 30, 2001 and 2000

**Intra-Governmental Assets**
*(In Millions)*

**Fiscal Year 2001**

| Agency | Fund Balance with Treasury | Due from Treasury | Accounts Receivable, Net | Advances to Government Agencies |
|---|---|---|---|---|
| Treasury | $ 2,067 | $ 1,419 | $ 27 | $ 128 |
| Other | - | - | 6 | - |
| **Total** | $ 2,067 | $ 1,419 | $ 33 | $ 128 |

**Fiscal Year 2000**

| Agency | Fund Balance with Treasury | Due from Treasury | Accounts Receivable, Net | Advances to Government Agencies |
|---|---|---|---|---|
| Treasury | $ 2,005 | $ 1,040 | $ 7 | $ 122 |
| Other | - | - | 4 | 41 |
| **Total** | $ 2,005 | $ 1,040 | $ 11 | $ 163 |

**Intra-Governmental Liabilities**
*(In Millions)*

**Fiscal Year 2001**

| Agency | Due to Treasury | Accrued Expenses | Accrued Payroll and Benefits | Other Liabilities |
|---|---|---|---|---|
| Treasury | $ 20,000 | $ 6 | $ - | $ - |
| Department of Labor | - | 8 | - | 85 |
| U.S. Postal Service | - | 20 | - | - |
| Office of Pers. Mgmt | - | 1 | 46 | - |
| Other | - | 8 | - | (4) |
| **Total** | $ 20,000 | $ 43 | $ 46 | $ 81 |

**Fiscal Year 2000**

| Agency | Due to Treasury | Accrued Expenses | Accrued Payroll and Benefits | Other Liabilities |
|---|---|---|---|---|
| Treasury | $ 22,000 | $ - | $ - | $ - |
| General Services Adm. | - | 7 | - | - |
| Department of Labor | - | - | - | 82 |
| Office of Pers. Mgmt | - | 10 | 41 | - |
| Other | - | 13 | | 5 |
| **Total** | $ 22,000 | $ 30 | $ 41 | $ 87 |

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**Internal Revenue Service**
**Supplemental Information - Unaudited**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Schedule of Budgetary Resources by Major Budget Accounts**
*(In Millions)*

| | Fiscal Year 2001 | | | | |
|---|---|---|---|---|---|
| | **Processing Assistance & Management** | **Tax Law Enforcement** | **Information Services** | **Information Technology Investment Account and Other** | **Total** |
| **Budgetary Resources** | | | | | |
| Budget authority | $ 3,755 | $ 3,450 | $ 1,608 | $ 301 | $ 9,114 |
| Unobligated balances – beginning of period | 168 | 90 | 187 | 346 | 791 |
| Spending authority from offsetting collections | 27 | 80 | 3 | 11 | 121 |
| Adjustments | 24 | (7) | (6) | (89) | (78) |
| **Total Budgetary Resources** | **$ 3,974** | **$ 3,613** | **$ 1,792** | **$ 569** | **$ 9,948** |
| **Status of Budgetary Resources** | | | | | |
| Obligations incurred | $ 3,800 | $ 3,548 | $ 1,700 | $ 459 | $ 9,507 |
| Unobligated balances – available | 58 | 13 | 27 | 98 | 196 |
| Unobligated balances – unavailable | 116 | 52 | 65 | 12 | 245 |
| **Total Status of Budgetary Resources** | **$ 3,974** | **$ 3,613** | **$ 1,792** | **$ 569** | **$ 9,948** |
| **Outlays** | | | | | |
| Obligations incurred | $ 3,800 | $ 3,548 | $ 1,700 | $ 459 | $ 9,507 |
| Less: spending authority from offsetting collections and adjustments | (79) | (99) | (35) | (18) | (231) |
| Obligated balances, net – beginning of period | 395 | 287 | 395 | 155 | 1,232 |
| Less: obligated balances, net – end of period | (556) | (299) | (559) | (221) | (1,635) |
| **Total Outlays** | **$ 3,560** | **$ 3,437** | **$ 1,501** | **$ 375** | **$ 8,873** |

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**Internal Revenue Service**
**Supplemental Information - Unaudited**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Schedule of Budgetary Resources by Major Budget Accounts**
*(In Millions)*

(Continued)

**Fiscal Year 2000**

| | Processing Assistance & Management | Tax Law Enforcement | Information Services | Information Technology Investment Account and Other | Total |
|---|---|---|---|---|---|
| **Budgetary Resources** | | | | | |
| Budget authority | $ 3,376 | $ 3,283 | $ 1,502 | $ 158 | $ 8,319 |
| Unobligated balances – beginning of period | 143 | 76 | 209 | 505 | 933 |
| Spending authority from offsetting collections | 28 | 61 | 12 | 6 | 107 |
| Adjustments | (22) | - | 9 | 1 | (12) |
| **Total Budgetary Resources** | **$ 3,525** | **$ 3,420** | **$ 1,732** | **$ 670** | **$ 9,347** |
| **Status of Budgetary Resources** | | | | | |
| Obligations incurred | $ 3,357 | $ 3,330 | $ 1,545 | $ 324 | $ 8,556 |
| Unobligated balances – available | 20 | - | 90 | 236 | 346* |
| Unobligated balances unavailable | 148 | 90 | 97 | 110 | 445 |
| **Total Status of Budgetary Resources** | **$ 3,525** | **$ 3,420** | **$ 1,732** | **$ 670** | **$ 9,347** |
| **Outlays** | | | | | |
| Obligations incurred | $ 3,357 | $ 3,330 | $ 1,545 | $ 324 | $ 8,556 |
| Less: spending authority from offsetting collections and adjustments | (49) | (74) | (50) | (7) | (180) |
| Obligated balances, net – beginning of period | 405 | 236 | 549 | 50 | 1,240 |
| Less: obligated balances, net – end of period | (395) | (287) | (395) | (155) | (1,232) |
| **Total Outlays** | **$ 3,318** | **$ 3,205** | **$ 1,649** | **$ 212** | **$ 8,384** |

* The Information Technology Investments fund comprised $211 of the unobligated available balance that could not be obligated as of September 30, 2000 because an expenditure plan had not been approved by Congress.

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**Internal Revenue Service**
**Other Accompanying Information - Unaudited**
**For the Fiscal Years Ended September 30, 2001 and 2000**

**Child Tax Credit**

The child tax credit was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In fiscal year 2001, the Service issued $972 million in child tax credit refunds. An additional $19.6 billion of child tax credits were applied to reduce taxpayer liability. In fiscal year 2000, the Service issued $809 million in child tax credit refunds. An additional $19.2 billion of child tax credits were applied to reduce taxpayer liability.

**Tax Gap**

The tax gap is the aggregate amount of tax imposed by the tax laws for any given tax year that is not paid voluntarily and timely, excluding interest and penalties. Although there is a tax gap for each type of tax, the Service does not have current information upon which to base a reasonable estimate of their magnitude.

The collection gap is the cumulative amount of assessed taxes, including penalties and interest, which the Service expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the Service's balance sheet. The tax gap and the collection gap are related and overlapping concepts. The collection gap includes all of the uncollectible taxes for a particular tax year of the tax gap, and uncollectible taxes from prior years.

**Tax Burden and Tax Expenditures**

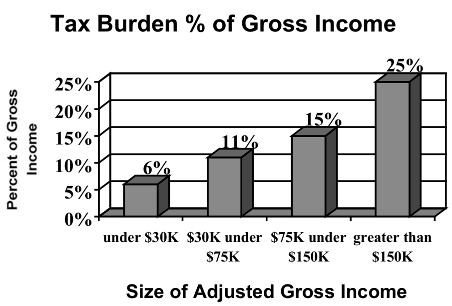
The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The bar charts and pie graphs below present the latest available information on income tax and on related income, deductions, and credits for individuals by income level and for corporations by size of assets. The information illustrates the tax burden borne by different income and asset brackets. The bar charts and pie graphs are only representative of more detailed data and analysis available from the Statistics of Income (SOI) office.

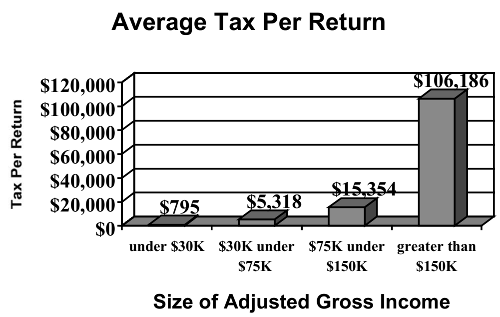
Total tax expenditures are the foregone federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available from government operations, decisions to forego federal revenue are as important as decisions to spend federal revenue.

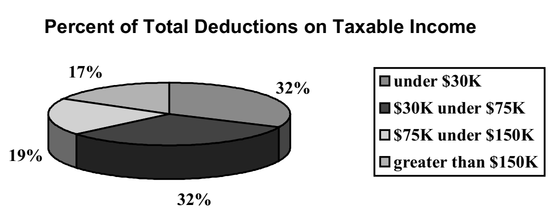
**Internal Revenue Service**
**Other Accompanying Information - Unaudited**
**For the Fiscal Years Ended September 30, 2001 and 2000**

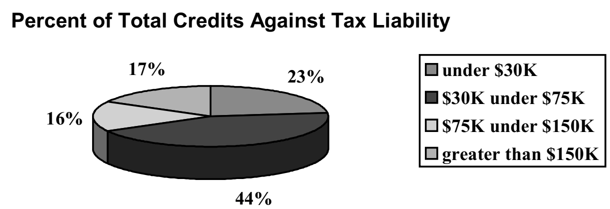
(All figures are estimates based on samples provided by the Statistics of Income office)
(K = Thousands)

**Individual Income Tax Returns (Tax Year 1999 Data)**

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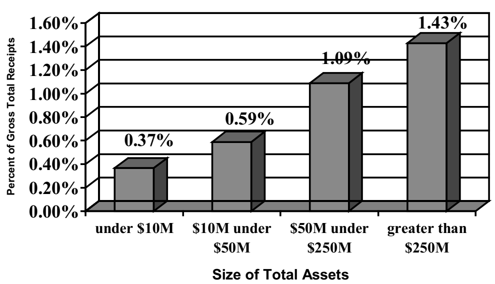
**Internal Revenue Service**
**Other Accompanying Information - Unaudited**
**For the Fiscal Years Ended September 30, 2001 and 2000**

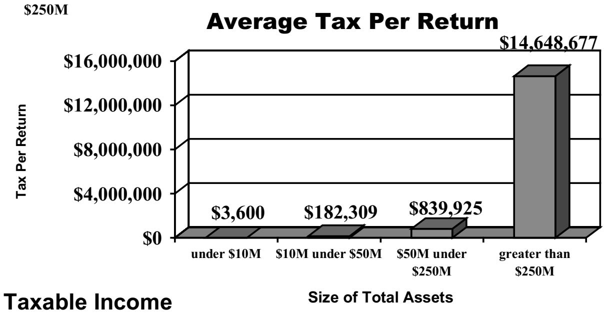
(All figures are estimates based on samples provided by the Statistics of Income office)
(M = Millions)

**Corporation Income Tax Returns (Tax Year 1998 Data)**

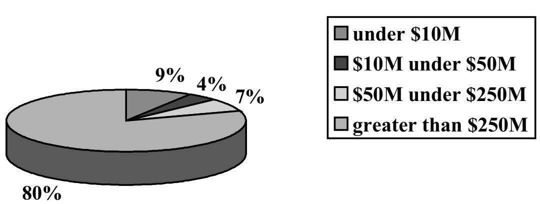
**Tax Burden % of Gross Income**



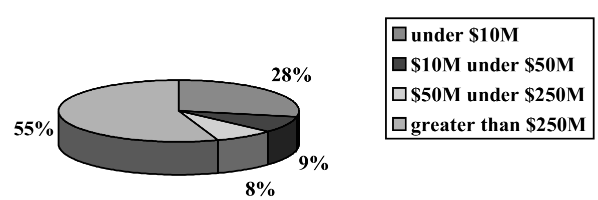

**Average Tax Per Return**




**Percent of Total Deductions on Taxable Income**




**Percent of Total Credits Against Tax Liability**

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# Material Weaknesses, Reportable Conditions, and Compliance Issues

## Material Weaknesses

During our audit of IRS's fiscal year 2001 financial statements, we identified six material weaknesses in internal controls. These material weaknesses have given rise to significant management challenges that have (1) impaired management's ability to timely prepare reliable financial statements and other financial information such as interim financial reports, (2) made it significantly more difficult for management to effectively manage the allocation of limited resources among competing priorities, (3) reduced IRS's effectiveness in enforcing the Internal Revenue Code, (4) resulted in errors in taxpayer accounts, and (5) increased taxpayer burden. The issues that we have identified and discuss in this report relate to IRS's controls over (1) financial reporting, (2) management of unpaid assessments, (3) federal tax revenue and refunds, (4) property and equipment, (5) budgetary activity, and (6) computer security. We reported on each of these issues last year.[9] We highlight these issues in the following sections. Less significant matters involving IRS's system of internal controls and its operations will be separately reported to IRS in a management letter.

## Financial Reporting

In fiscal year 2001, as in prior years, IRS did not have internal controls over its financial reporting process adequate to enable it to timely, routinely, and reliably generate and report the information needed to prepare financial statements and manage operations on an ongoing basis. During fiscal year 2001, IRS did not have (1) an adequate general ledger system for financial reporting and management purposes, (2) adequate internal controls over material balances maintained in its general ledger system and recording of financial transactions, (3) a cost accounting system capable of providing timely and reliable cost information related to IRS's activities and programs, and (4) the ability to separately report several of the federal government's largest types of revenue collections. These conditions also limited IRS's ability to prepare useful and reliable interim financial statements. To compensate for these weaknesses, IRS continued to depend on extensive, labor-intensive compensating procedures to enable it to generate management information and report reliable balances in its financial statements at year-end. Although this approach culminated in financial statements that were fairly stated as of September 30, 2001 and 2000, it cannot produce current data needed to manage operations on an

[9]GAO-01-394.

ongoing basis, such as preparing reliable cost-benefit analysis to assist in making resource allocation decisions.

As we reported in previous years,[10] during fiscal year 2001, IRS's general ledger system (1) comprised two independent general ledgers that are not integrated with each other nor with their supporting records for material balances,[11] and (2) was not supported by adequate audit trails for federal tax revenue, federal tax refunds, taxes receivable, property and equipment, or budgetary activity. In addition, IRS's general ledger for its custodial activities does not use the standard federal accounting classification structure. Because of these deficiencies, IRS's general ledger system does not conform to the *U.S. Government Standard General Ledger* (SGL) as required by the *Core Financial System Requirements* of the Joint Financial Management Improvement Program[12] or the requirements of FFMIA. In its Management Discussion and Analysis (MD&A), IRS discusses its plans to implement a single, integrated general ledger that will be fully compliant with FFMIA. However, it is unclear when this will be accomplished, and thus when IRS will have a functional general ledger that is fully compliant with FFMIA, including being supported by detailed subsidiary records for its administrative and custodial accounts.

Also, during fiscal year 2001, IRS did not have internal controls over its general ledger system adequate to provide reasonable assurance that its balances were current and accurate on an ongoing basis. IRS did not record material transactions in its general ledger system until months after they occurred. For example, IRS did not record its imputed costs[13] for fiscal year 2001 until year-end, although such costs are readily estimable. In addition, IRS did not always correct discrepancies it identified during interim periods. In fiscal year 2001, IRS began comparing material related proprietary and budgetary accounts to identify discrepancies. This is an

[10]GAO-01-394, and U.S. General Accounting Office, *Internal Revenue Service: Progress Made, but Further Actions Needed to Improve Financial Management* GAO-02-35, (Washington, D.C.: October 19, 2001).

[11]IRS's two independent general ledgers separately support its administrative and custodial operations.

[12]The Joint Financial Management Improvement Program (JFMIP) is a cooperative undertaking of the Office of Management and Budget, the Department of the Treasury, the Office of Personnel Management, and GAO working in cooperation with each other and with operating agencies to improve financial management practices.

[13]Imputed costs are IRS costs that have been paid in part or in full by other entities.

important control for ensuring the reliability of financial records. However, we found that this control was not effective because IRS did not make timely adjustments to its general ledger to correct the discrepancies it identified. As a result of these problems, material account balances in the general ledger systems remained unreliable at interim periods. These problems also rendered IRS unable to rely on its general ledger system to support its year-end financial statements without extensive, time-consuming processes designed to compensate for such deficiencies.

We also found that IRS continued to lack a cost accounting system (1) capable of accurately and timely tracking and reporting the costs of IRS's programs and projects to assist it in managing its costs and (2) meeting the JFMIP *Systems Requirements for Managerial Cost Accounting*. This condition also renders IRS unable to produce reliable cost-based performance information. IRS officials have indicated that IRS's records contain information necessary to enable them to determine the cost of various activities, such as conducting investigations. However, this information is widely distributed among a variety of information systems, thereby making the accumulation of cost information time-consuming, labor-intensive, and not readily available as a tool to manage costs. For example:

- IRS uses the Project Cost Accounting System (PCAS) to capture costs of information systems projects at the project level by recording certain codes for time charges. However, IRS only required that PCAS be used by employees working on information systems-related projects, which accounted for about 18 percent of IRS's budgetary resources in fiscal year 2001.
- IRS has a variety of workload management systems that staff in different units use to track how their time is spent on specific tasks. However, these systems are not integrated with IRS's general ledger or each other to allow IRS to readily identify and accumulate the total costs for time spent by all units involved in any specific activity.

In addition, neither PCAS nor IRS's workload management systems are designed to track certain material forms of non-personnel costs by project and subproject, such as equipment depreciation, rent, and utilities.

Without a cost accounting system to centrally accumulate, organize, and timely report cost data in a format that meets management's current needs, such information is not readily available for use by managers to aid in routinely managing costs and in decision-making. Instead, IRS often finds it

necessary to conduct special research efforts tailored to determine the cost of a specific task or project. IRS currently has a cost accounting system under development that is scheduled for implementation in October 2003.

IRS also continues to be unable to determine the specific amount of revenue it actually collects for three of the federal government's four largest revenue sources—Social Security, hospital insurance, and individual income taxes. In addition, IRS continues to be unable to determine, at the time payments are received, collections for the Highway Trust Fund or other trust funds that receive excise tax receipts. This is primarily because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. Further, the information on the tax return pertains only to the amount of the tax liability, not to the distribution of the amount previously collected. IRS does not require taxpayers to submit information identifying the type of tax at the time of payment because it believes that imposing such a requirement would create an additional burden to taxpayers. In addition, IRS's systems cannot presently capture and report such information routinely. IRS is working on systems improvements to accommodate this type of information in the future, and plans to initiate a study in the next 2 to 3 years to gauge taxpayer ability and readiness to provide such information at the time of payment without imposing an additional burden on taxpayers. Until IRS has the systems capability to record, and makes a decision with respect to whether taxpayers should provide this information, it will continue to be unable to timely report the specific amount of revenue it actually collected for these large revenue sources. This condition also makes the federal government rely on a complex, error prone, multi-step process to distribute excise taxes to the recipient trust funds.

As a result of these pervasive financial reporting weaknesses, IRS was unable to timely prepare reliable financial statements or other financial information that Congress and senior IRS management could rely on to oversee and assist in managing operations during fiscal year 2001. Consequently, IRS was compelled to make certain business decisions affecting the disposition of tens of billions of dollars without current and reliable underlying financial information. For example, for each of the following taxpayer compliance issues, IRS indicated that resource limitations affected its ability to perform necessary follow-up but could not readily determine or justify whether it would be cost-beneficial to devote additional resources for such follow-up:

- From 1996 to 1999, IRS only followed-up on 21 percent of the over 53 million underreported individual income tax cases it identified, which accounted for about 41 percent of the over $65 billion in underreported taxes IRS estimated on these cases.
- As of September 30, 2001, IRS had either not started collection action or had stopped collection action in progress on unpaid tax assessment cases with outstanding balances totaling about $12 billion because it did not believe it had the resources to actively seek collection.
- IRS follows-up on only a portion of the suspicious Earned Income Tax Credit (EITC) claims it identifies, although the EITC has historically been subject to high rates of invalid claims. The amount of improper payments included in the almost $26 billion IRS disbursed for EITC in fiscal year 2001 is unknown.

In deciding on the amount of resources to devote to follow-up on these cases, IRS should consider factors such as the effects on fairness to taxpayers and efforts to deter filing fraud. The relative costs and benefits involved in following up on questionable cases should also be an integral part of such decisions. However, in each of these circumstances, IRS was not able to readily determine (1) the cost of following up on cases or (2) how much it collected on those cases for which it did follow-up. Without this information, IRS cannot perform cost-benefit analysis to assist it in determining or justifying whether the amount of resources it has devoted to each of these programs is appropriate relative to costs and potential benefits involved.[14] Consequently, IRS is hindered in its ability to justify its resource utilization decisions or provide justification for resource increases, which could result in billions of dollars of revenue going uncollected, lead to further erosion in taxpayers' confidence in the equity of the tax system, and adversely affect future compliance.

[14] A cost-benefit analysis would consider the costs and expected benefits, both direct and indirect, in increasing resources to pursue collections of outstanding taxes or recovery of improper refund payments. These benefits could include not only increased collections of outstanding taxes and recoveries of improper refund payments, but also benefits to taxpayers through earlier IRS action that might prevent a build up of the outstanding tax liabilities. Improved compliance by taxpayers with the nation's tax laws could also be a benefit.

## Management of Unpaid Tax Assessments

During fiscal year 2001, we continued to find serious internal control issues that affected IRS's management of unpaid assessments. Specifically, we found (1) IRS continued to lack a subsidiary ledger for unpaid assessments that would allow it to produce timely and useful information with which to manage and report externally, and (2) errors and delays in recording taxpayer information, payments, and other activities that continued to hinder IRS's ability to effectively manage its unpaid assessments. [15]

IRS's management of unpaid assessments is hindered by a lack of effective supporting systems. IRS lacks a detailed listing, or subsidiary ledger, that tracks and accumulates unpaid assessments and their status on an ongoing basis. As a result, IRS must rely on a costly, manual, labor-intensive compensating process for external reporting. Specifically, to report balances for taxes receivable and other unpaid assessments in its financial statements and supplemental information, IRS must apply statistical sampling and projection techniques to data in its master files[16] to estimate the balances at year-end. This process takes months to complete, requires adjustments totaling tens of billions of dollars, and produces amounts that are only reliable as of the last day of the fiscal year. Consequently, this information is not useful for ongoing management decisions. In addition, the lack of a subsidiary ledger renders IRS unable to timely develop reliable financial and management reports and promptly identify and focus collection efforts on accounts most likely to prove collectible.

[15]Unpaid assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements. As of September 30, 2001, IRS reported $20 billion (net of an allowance for doubtful accounts of $60 billion), $23 billion, and $137 billion in these three categories, respectively.

[16]IRS's master file contains detailed records of taxpayer accounts. However, the master files do not contain all the details necessary to properly classify or estimate collectibility for unpaid assessment accounts.

IRS's management of unpaid assessments also continued to be hindered by inaccurate tax records. We continued to find errors and omissions in taxpayer records resulting from IRS's failure to accurately and timely record information. As in prior years, the most prevalent errors we found involved IRS's failure to record payments to all related taxpayers associated with unpaid payroll taxes.[17] IRS's current systems cannot automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or an officer pays some or all of the outstanding taxes, IRS's systems are unable to automatically reflect the payment as a reduction in the related account or accounts. In reviewing 67 unpaid payroll tax cases where one or more individuals were assessed a trust fund recovery penalty, we found 20 cases in which payments were not recorded in all related taxpayer accounts. Based on the results of our work, we estimate that 37 percent of unpaid payroll tax cases involving trust fund recovery penalties include payments that were not accurately recorded to reflect each responsible party's reduction in tax liability.[18] IRS has attempted to compensate for the lack of an automated link between related accounts by manually inputting a code in each account that cross-references it to other related accounts. However, of the 20 cases with unrecorded payments, 14 (70 percent) had all the necessary cross-references, and in 12 of these cases, the payments were made after the cross-references had been added to the accounts.

We found other errors in taxpayer accounts, which IRS took a significant amount of time to correct. For example, in one case we reviewed, a business filed a return reflecting a tax liability of about $1.9 million. However, IRS erroneously recorded a tax debt of over $34 million for the business. It took IRS over a year to correct the records. In the interim, IRS withheld $600,000 that it should have refunded to the business. Delays and errors in recording activity in taxpayer accounts complicate IRS's efforts to derive a reliable balance for unpaid assessments for its financial statements. Additionally, failure to record payments and other activity

[17]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. The assessments made against business officers are known as trust fund recovery penalties.

[18]We are 95 percent confident that the confidence interval around this estimate ranges from 16 percent to 59 percent.

timely could result in taxpayer burden, including having enforcement actions taken against them for taxes they do not owe or which have already been paid.

We have reported on these issues in previous audits.[19] IRS has acknowledged the seriousness of these issues and continues to take remedial steps to address their impact. The ultimate solution to many of these issues is the successful modernization of IRS's systems, which IRS acknowledges will take several years to complete.

## Tax Revenue and Refunds

During fiscal year 2001, we found that IRS's controls were not fully effective in maximizing the government's ability to collect what is owed and in minimizing the risk of payment of improper refunds. IRS recognized this in its fiscal year 2001 FIA assurance statement to the Treasury, in which it reported a material weakness in EITC and other filing fraud. IRS's taxpayer compliance programs identify billions of dollars of potentially underreported taxes and invalid EITC each year. However, due in large part to perceived resource constraints, IRS selects only a portion of the questionable cases it identifies for follow-up investigation and action. In addition, IRS often does not initiate follow-up on the cases it selects until months after the related tax returns have been filed and any related refunds disbursed, affecting its chances of collecting amounts due on these cases. Consequently, the federal government is exposed to potentially significant losses from reduced revenue and disbursements of improper refunds. However, as discussed previously in the material weakness in financial reporting, IRS's financial management systems do not currently provide the timely, reliable information management needs to assess whether the levels of resources it expends on these activities are commensurate with the costs to be incurred and the benefits that could be realized from such efforts.

[19] GAO-01-394.

The options available to IRS in its efforts to identify and pursue the correct amount of taxes owed and to ensure that only valid refunds are disbursed are currently limited. For example, third-party information such as form 1099s[20] that can corroborate the amount of income reported by taxpayers are not required to be filed until after the start of the tax filing season.[21] Consequently, comparison of such information with tax return data is problematic because IRS does not have time to prepare the third-party data for matching prior to the receipt of individual tax returns. Additionally, while it processes hundreds of millions of tax returns each filing season, IRS must issue refunds within statutory time constraints or be subject to interest charges.[22]

Nonetheless, IRS does have some preventive controls that, if effectively implemented, could help to reduce the risks associated with not identifying underreported taxes owed or issuing improper refunds. For example, IRS's Examination Branch is responsible for performing examinations on tax returns with potentially invalid EITC claims[23] to determine the validity of the claim. When performed before refunds are disbursed, these examinations are an important control to prevent disbursement of improper refunds. However, these examinations are often performed after any related refunds are disbursed. Consequently, they are not an effective preventive control overall. In September 2000, IRS estimated that of about $30 billion in EITC claims filed by taxpayers in tax year 1997, about $9.3 billion (31 percent) were invalid.[24] Of this amount, only $1.5 billion (16 percent) was either recovered or expected to be recovered through compliance efforts. The dollar amount of improper refunds disbursed related to these invalid EITCs is unknown. However, based on the tax year 1997 refund rate, which was about 78 percent, IRS may have disbursed

[20]IRS 1099 forms are used by third parties, such as financial institutions, to report taxpayers' interest income, dividend distributions, and other miscellaneous income.

[21]The peak tax filing season primarily occurs from January 1 to April 15 of each year.

[22]By statute, IRS must pay interest on refunds not paid within 45 days of receipt or due date, whichever is later (26 U.S.C. §6611).

[23]Because it is a tax credit, an EITC claim always results in a reduction of the taxpayer's calculated tax liability. However, depending on the taxpayer's amount of taxes withheld, it may or may not result in a refund for a particular tax year.

[24]Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns* (Washington, D.C.: September 2000). IRS's study on tax year 1999 was still being completed at the time of our audit.

about $7.3 billion in EITC-related improper refunds in tax year 1997, of which about $6.1 billion (84 percent) may never be recovered. The full magnitude of improper refunds disbursed annually due to invalid EITCs is unknown. IRS is currently in the final year of a 5-year initiative started in fiscal year 1998 to address noncompliance problems with EITCs.

Due to time and other constraints, IRS relies extensively on detective controls, such as automated matching of returns with third-party data such as W-2s (wage and tax statements) to identify for collection underreported taxes and improper refunds. However, these programs are not run until months after the returns have been filed. As a result, they are used too late to prevent improper refunds from being disbursed. In addition, although IRS's matching program for individual tax returns identifies billions of dollars of potentially underreported taxes each year, IRS only follows up on a portion of these cases to determine how much tax is actually due and to pursue collection of those amounts. For example, for tax year 1999,[25] IRS's matching program for individuals identified 14.2 million individual tax returns with potential underreported taxes totaling $16.2 billion. IRS investigated 2.9 million (20 percent) of these returns accounting for about $7.1 billion (44 percent) of the total potential underreported taxes. There are factors that affect IRS's ability to accelerate the timing of its automated matches, such as the limitations of its current automated systems and the timing of filing requirements for preparers of third-party documents, which are beyond IRS's control. However, the results of IRS's efforts to follow up on findings of its automated matches suggests that a substantial amount of additional revenue might be realized if additional resources were devoted to these efforts.

IRS's decisions to forgo follow-up examinations on invalid EITC claims and potentially underreported taxes were based in part on perceived resource constraints. However, as discussed previously, IRS's financial management systems do not currently provide the timely, reliable information management needs to perform cost-benefit analyses to assist in determining the appropriate level of resources to devote to these compliance programs. As a result of these problems, billions of dollars of underreported taxes could remain uncollected and improper refunds could

[25]Individual tax returns are not due until April 15 of the following year (up to October 15 if extensions are filed), and the under-reporter screening programs cannot be run until after the returns are filed. Consequently, tax year 1999 is the most recently completed tax year for which the cited data are available.

be disbursed. This, in turn, could further erode taxpayer confidence in the equity of the tax system and reduce compliance with the tax laws.

## Property and Equipment

In fiscal year 2000, we reported that material weaknesses in IRS's property and equipment (P&E) systems and controls prevented it from having (1) P&E information available on an ongoing basis, and (2) reasonable assurance that its assets were properly safeguarded and used only in accordance with management policy.[26] During fiscal year 2001, IRS continued efforts to correct these longstanding deficiencies in systems and controls over its P&E. Specifically, IRS (1) implemented a new inventory record system for its automated data processing assets, and (2) developed policies and procedures to identify and record costs incurred to develop internal use software. However, fundamental deficiencies in IRS's financial management system continued to exist, which precluded it from having ongoing information on its balance of P&E. To compensate for this, IRS relied on compensating procedures to extract the cost of P&E acquisitions from its accounting records. This approach enabled IRS to report a reliable balance for P&E on its financial statements at September 30, 2001, but it did not (1) enable IRS to produce the current, reliable information it needs to manage P&E on an ongoing basis, or (2) provide assurance that assets are properly safeguarded and used only in accordance with IRS policy. IRS has reported a material weakness in its controls over P&E in its annual assurance statement to Treasury required under 31 U.S.C. §3512 (c), (d) (FIA) every year since 1983.

As we previously reported, IRS does not have an integrated property management system that appropriately records P&E additions and disposals as they occur and links costs on the accounting records to property records. Additionally, during fiscal year 2001, IRS continued to lack procedures to record P&E assets and the corresponding liabilities in its accounting system as transactions occur. Instead, IRS expenses property purchases throughout the year, then records adjustments after year-end to remove property acquisition costs from its expense account and capitalize them as P&E based on analyses of expense records. Consequently, IRS does not have reliable P&E data available on an ongoing basis to make operational decisions related to the acquisition and use of P&E. IRS hired a contractor to extract, analyze and compile the data

[26]GAO-01-394.

needed to report a reliable P&E balance in its financial statements after fiscal year-end. However, this process takes several months to complete. For example, P&E information for the fiscal year ending September 30, 2001, was not available for our review until December 2001.

Accurate records are essential for maintaining control over P&E to ensure that assets are properly accounted for and safeguarded. In an effort to improve accountability over its P&E in fiscal year 2001, IRS implemented a new inventory record system for its automated data processing P&E and established units with specific responsibility for maintaining the accuracy of its inventory records. However, this new inventory record system did not capture information essential to ensure that software and software licenses were properly controlled and used only in accordance with license agreements. Additionally, while we noted improvement in the accuracy of IRS's inventory records during fiscal year 2001, we nonetheless continued to find that IRS's procedures for recording P&E acquisitions, disposals and transfers did not ensure that transactions were promptly and accurately recorded. Specifically, we found that 25 of 210 P&E items we tested at 21 sites, including computers, monitors, and printers, could not be located at the time of our review.[27] At one site, 5 of 10 sample items we selected from the inventory records could not be located. Based on our work, we estimate that 12 percent of the items in IRS's P&E inventory records were erroneously included as assets.[28] As a result, IRS's P&E records were not adequate to maintain accountability over its property.

These longstanding weaknesses in IRS's property and accounting systems continue to affect IRS's ability to account for its property and report a reliable P&E balance on an ongoing basis. These weaknesses will continue to exist until IRS has an integrated accounting and property management system. IRS plans to acquire and install a fixed asset module to the integrated financial system that will include recording P&E as assets when purchased and generating detailed records for P&E that reconcile to the

[27]For our floor-to-book sample, we obtained a representative selection of P&E items with a two-stage cluster sample. In the first stage, we selected a representative sample of 21 buildings. In the second stage, we selected a representative sample of 10 assets located at each of the 21 buildings from the asset records of the ADP and non-ADP P&E inventory systems.

[28]We are 90 percent confident that the confidence interval around this estimate ranges from 6 percent to 19 percent.

financial records. IRS currently plans to have the fixed asset module installed by March 2005.

## Budgetary Activity

We previously reported that internal control deficiencies over appropriated funds prevented IRS from ensuring that its budgetary authority[29] was routinely accounted for, reported, and controlled.[30] In fiscal year 2001, IRS developed compensating procedures to address several of the budgetary control weaknesses we previously reported. Specifically, IRS (1) developed procedures to identify and eliminate from the applicable general ledger accounts transactions that were incorrectly recorded as adjustments to prior years' obligations[31] and (2) revised its accrual methodology to address reported deficiencies in controls over the accurate recording of undelivered orders[32] and accrued expenses. However, IRS did not apply its compensating procedures throughout the fiscal year. Additionally, we continued to find instances in which IRS did not timely record obligations. As a result, IRS's internal controls did not ensure that its budgetary resources were routinely accounted for, reported, and controlled. Without adequate budgetary controls, IRS cannot ensure the reliability of key budgetary information it needs on an ongoing basis to manage its operations and ensure that its obligations do not exceed budgetary authority.

[29]Budget authority is the authority provided by law to enter into financial obligations that will result in immediate or future outlays involving federal government funds.

[30]GAO-01-394 and GAO-02-35.

[31]An adjustment to a prior year's obligation is recorded when the dollar amount previously recorded is affected by a subsequent event, such as a change in the price of goods or services.

[32]Undelivered orders represent the value of goods and services that have been ordered and obligated but have not been received.

During fiscal year 2001, we found that IRS continued to record certain activities as adjustments to prior years' obligations that were not valid adjustments to those obligations. This occurred because IRS's accounting system records all adjustments that affect a prior year's appropriation, including those that did not affect the obligated amount, as adjustments to prior years' obligations. To identify the valid fiscal year 2001 adjustments to prior years' obligations, IRS manually analyzed the adjustment activity recorded in its accounting system. IRS then used the results of this analysis to record adjusting entries to the applicable general ledger accounts at the end of the fiscal year. Of the $1.4 billion in adjustments to prior years' obligated balances IRS recorded in its accounting system in fiscal year 2001, nearly $1.1 billion were not valid. Although IRS made adjusting entries to prevent its financial statements from being misstated, its records of adjustments and obligated balances were misstated throughout the fiscal year. Recording all adjustments that affect a prior year's appropriation as adjustments to prior years' obligations adversely affects IRS's ability to routinely report accurate and reliable information on total budgetary resources and obligations. IRS reports adjustments to prior years' obligations as part of its SF133 *Report on Budget Execution and Budgetary Resources*, submitted quarterly to OMB.[33] Because the adjustment accounts were misstated during the year, interim data IRS reported to OMB on its budgetary activities were not accurate.

In prior audits, we found instances in which IRS received goods and services during one fiscal year but did not record the applicable expenditure to reduce the undelivered orders balance in its accounting system until the following fiscal year. This resulted in IRS overstating its balance of undelivered orders and understating its accrued expenses. During fiscal year 2001, IRS developed a methodology to more reasonably accrue expenditures at year-end and thus recognize the associated reduction in the balance of undelivered orders. Application of this methodology resulted in IRS being able to report reliable amounts for fiscal year-end undelivered orders and accrued expenses on its financial statements. However, IRS's balance of undelivered orders was not accurate throughout fiscal year 2001 due to delays in recording expenditures. Specifically, in testing 115 undelivered orders, we identified 35 instances in which IRS took over 30 days from the date it accepted the goods or services to record the applicable expenditure in its accounting system. Untimely

[33]OMB requires that each agency submit an SF133 quarterly to report its budget execution as well as the status of its budgetary resources.

recording of expenditures affects IRS's ability to efficiently manage its budgetary resources by delaying the identification of obligated funds that (1) are insufficient to cover the expenditure or (2) can be deobligated and made available for future or existing obligations.

We also found that IRS continued to experience delays in recording obligations in its accounting system during fiscal year 2001. In testing 115 undelivered orders, we found 9 instances where IRS took over 30 days from the date the obligation document was established to record the obligated amount in its accounting system, and 5 instances in which IRS incurred costs prior to recording the obligation in its accounting system. For example:

- In one instance, IRS established an obligation on June 7, 2001, for data processing services totaling $400,000. However, IRS did not record the obligation in its accounting system until September 7, 2001—3 months after the obligation was established.
- In another instance, IRS received telecommunication services that covered the period October 1, 2000, through December 31, 2000, at a cost of $5.9 million. However, IRS did not generate the initial obligating document to establish the obligation of funds until January 26, 2001, and recorded the obligation in its accounting system on January 29, 2001—over 3 months after the services were initiated.

Delays in recording obligations affect the reliability of IRS's financial records used to track the status of its budgetary resources for day-to-day decision-making. Until the obligation of funds is recorded, obligations reflected in IRS's accounting system would be understated. This could lead IRS management to believe that the agency has more funding than is actually available. Consequently, IRS management and personnel might enter into additional obligations in excess of the budgetary authority made available by Congress.

## Computer Security

IRS relies extensively on computer information systems to perform basic functions, such as processing tax returns and payments, maintaining sensitive taxpayer data, calculating interest and penalties, and generating refunds. Although IRS has corrected or mitigated many of the computer security weaknesses identified in our previous reports, much remains to be done to resolve the significant control weaknesses that continue to exist within IRS's computing environment and to be able to promptly address new security threats and risks as they emerge. Such weaknesses can impair

the agency's ability to perform vital functions, and can increase the risk of unauthorized disclosure, modification, or destruction of taxpayer data.

IRS has continued to make progress improving computer security controls. For example, IRS has strengthened certain controls over its mainframe systems, updated security standards for its Windows NT and Unix computing environments, upgraded the operating system for its workstations, installed security upgrades over its electronic tax filing systems,[34] and improved certain physical security controls at its data processing facilities. IRS is also consolidating several of its geographically dispersed Unix computer systems and centralizing responsibility for their operation and management, performing periodic internal control reviews of its computer-processing environments, and implementing an intrusion detection capability.

However, IRS continued to have serious weaknesses in fiscal year 2001 with computer controls designed to protect computing resources such as networks, computer equipment, software programs, data, and facilities from unauthorized use, modification, loss, and disclosure. For example, IRS did not always effectively configure and implement computer systems in accordance with its own computer security guidelines, monitor system configuration and implementation, and provide sufficient technical security-related training to key personnel. In addition, IRS has not taken sufficient steps to ensure that internal control deficiencies are considered and addressed at other facilities. IRS did not always

- adequately restrict electronic access to or within its computer networks and systems;
- appropriately segregate system administration and security administration responsibilities;
- optimally configure system software to ensure the security and integrity of system programs, files, and data;
- sufficiently plan or test the activities required to restore certain critical business systems when unexpected events occur;
- effectively monitor key networks and systems to identify unauthorized activities and inappropriate system configurations; and
- adequately ensure that access to key computer applications was limited to authorized persons for authorized purposes.

[34] U.S. General Accounting Office, *Information Security: IRS Electronic Filing Systems*, GAO-01-306 (Washington, D.C.: February 16, 2001).

Collectively, these problems indicate material weaknesses in IRS's internal controls over information systems and data. These weaknesses decreased the reliability and increased the vulnerability of data processed by the systems. Until IRS can adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software, and intentionally or inadvertently add, alter, or delete sensitive data or computer programs. Such individuals could also obtain personal taxpayer information and use it to commit financial crimes in the taxpayers' names (identity fraud), such as establishing credit and incurring debt.

## Reportable Conditions

In addition to the material weaknesses discussed above, we identified one reportable condition. This concerns weaknesses in IRS's internal controls over manually processed tax receipts and taxpayer information that we have reported in prior years.[35] The reportable condition related to revenue reporting and distribution that we reported in prior years continues to exist, but is now included as part of the material weakness in financial reporting.

### Manual Tax Receipts and Taxpayer Information

During fiscal year 2001, IRS's controls over cash, checks, and related hard-copy taxpayer data it receives from taxpayers continued to be inadequate to sufficiently limit the risk of theft, loss, or misuse of such funds and data. Recognizing its responsibility to protect taxpayer information and receipts, IRS has taken action in the past several years to address a number of its control deficiencies. For example, IRS began conducting periodic security reviews of receipt processing areas, implemented many of its new hiring and courier standards, and updated policies and procedures to improve the safeguarding of taxpayer receipts and data. Nonetheless, IRS's actions did not adequately address its control deficiencies primarily due to inconsistencies in the establishment, implementation, and compliance with these policies at IRS service center campuses, field offices, and commercial lockbox banks that process tax receipts on behalf of IRS.

[35]GAO-01-394.

We previously reported that IRS was hiring individuals and allowing them access to cash, checks, and other taxpayer data before it received satisfactory results of their fingerprint checks.[36] Specifically, we noted that of approximately 19,600 employees hired during fiscal year 2000, about 4,900 (25 percent) were hired and began working prior to IRS's receipt and evaluation of their fingerprint checks. In response, IRS issued a final policy in August 2000 prohibiting new hires from entering on duty in any IRS office until fingerprint checks were completed and case dispositions evaluated. IRS has made significant progress on this issue during fiscal year 2001. Nevertheless, based on our review of IRS and Office of Personnel Management (OPM)[37] data, we found that 104 of the over 20,000 individuals IRS hired in fiscal year 2001 began working at IRS facilities before IRS received and evaluated the results of their fingerprint checks. Of these 104 employees, 53 (51 percent) were not fingerprinted until the day they entered on duty or later, including 15 employees who were not fingerprinted until 1 to 3 months after they entered on duty. In addition, for 24 other employees, neither IRS nor OPM had a record of fingerprint checks being completed.

IRS has demonstrated a concerted effort to address courier security weaknesses by adopting more stringent security standards for couriers that transport IRS's daily deposits to depository institutions. Specifically, IRS's courier policy requires that (1) courier services use two bonded or insured couriers, (2) courier service employees with IRS access pass a limited background investigation, and (3) the courier company be insured for $1 million. However, IRS did not have effective controls in place to ensure that the new requirements were enforced. At the two IRS service center campuses we visited, we found that local management did not obtain evidence to ensure that the courier services they entrusted with the daily deposits met the insurance coverage requirements, nor did they ensure that couriers, at a minimum, had completed fingerprint checks before they began transporting deposits for IRS.

[36]GAO-01-394 and GAO-02-35.

[37]OPM processes fingerprint requests and results for IRS.

We also found other weaknesses and inconsistencies in controls over taxpayer receipts and taxpayer data at service center campuses and field offices that have not yet been adequately addressed. For example, we continued to find discovered remittances[38] and other receipts stored in open, unlocked containers, contrary to IRS policy. Another IRS policy limits personal belongings that each worker can bring into receipt processing areas to small items that could fit into a clear, plastic bag, and specifically prohibits large items such as purses and backpacks. However, one service center campus we visited interpreted this policy to allow employees to bring in purses and backpacks as long as they were made of clear plastic. As a result, at this site we observed employees using large, clear plastic backpacks and tote bags to carry multiple personal belongings such as lunch bags, makeup bags, and items of clothing into receipt processing areas. Although the backpacks and other carrying bags were transparent, they contained so many items that it would be easy for an employee to use them to conceal and remove checks from the receipt processing area. In contrast, employees at another service center campus that followed the national policy were only allowed to bring into the receipt processing area small items that fit into one clear quart-sized plastic bag.

These inconsistencies are further illustrated by control weaknesses found at commercial lockbox banks that process tax receipts on behalf of IRS. These lockbox banks operate under contract with Treasury's Financial Management Service (FMS), and many of IRS's policies have not been required of the lockbox banks. For example, the contract requirements[39] between FMS and the lockbox banks in place throughout calendar year 2001 did not prohibit the banks from hiring new employees before the results of fingerprint checks were received and reviewed. Consequently, at the two lockbox banks we visited, we found that fingerprint checks were not always performed or required for either permanent or temporary employees. Similarly, IRS's courier policy requirements that apply to IRS locations have not been required of the lockbox banks. IRS officials told us the lockbox contract requirements effective for calendar year 2002 would contain hiring and courier requirements consistent with IRS requirements. However, we found the requirements did not prohibit permanent lockbox

[38] Discovered remittances are cash and/or checks that were erroneously overlooked during the extraction process.

[39] The lockbox contracts specify general guidelines to be followed. The more detailed requirements are laid out in the annual *lockbox processing guidelines*, which all of the lockbox banks are required to follow.

employees from starting work before their fingerprint check results were received by lockbox management as required of all IRS employees, nor did they require lockbox courier service employees to pass a limited background investigation as required of couriers used by IRS service center campuses.

These weaknesses increase IRS's vulnerability to theft or loss and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS. Thus, it is important that IRS effectively address these matters because they are critical to IRS successfully meeting its customer service goals.

## Compliance Issues

Our tests of compliance with selected provisions of laws and regulations disclosed one instance of noncompliance that is reportable under U.S. generally accepted government auditing standards and OMB guidance. This relates to IRS's timing of the release of federal tax liens against taxpayers' property. We also found that IRS's financial management systems do not substantially comply with the requirements of FFMIA.

In previous audits, we reported that IRS was not in compliance with Section 6159 of the Internal Revenue Code, which requires that the terms of installment agreements IRS enters into with taxpayers with outstanding tax liabilities provide for full satisfaction of the outstanding tax liability, including future interest accruals. In our testing of installment agreements IRS entered into with taxpayers during fiscal year 2001, we did not identify any instances of material noncompliance with this statute.[40]

[40]This does not mean that all installment agreements IRS entered into with taxpayers during fiscal year 2001 were structured to provide for full satisfaction of the tax liability. In addition, installment agreements IRS entered into with taxpayers in previous years may not be so structured, as evidenced by our prior audits. Based on the results of testing for a statistical sample of 59 installment agreements IRS entered into with taxpayers during fiscal year 2001, we are 95 percent confident that the rate of occurrence of installment agreements entered into during fiscal year 2001 whose terms do not require full satisfaction of the tax liability did not exceed 5 percent.

## IRS Did Not Always Release Federal Tax Liens in Accordance with the Internal Revenue Code

The Internal Revenue Code grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. The lien becomes effective when it is filed with a designated office, such as a courthouse in the county where the taxpayer's property is located. The lien serves to protect the interest of the federal government and serves as a public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in credit reports of individuals. Under section 6325 of the Internal Revenue Code, IRS is required to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

In previous audits, we found that IRS did not always release the applicable federal tax lien within 30 days of the tax liability being either paid off or abated as required.[41] We found that this condition continued to exist during fiscal year 2001. Specifically, in our testing of 59 tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2001, we found 5 instances in which IRS did not release the applicable federal tax lien within the 30-day statutory requirement. The time between satisfaction of the liability and release of the lien ranged from about 146 to over 300 days. In one case, we found that although the taxpayer had paid off the outstanding tax liability by December 2000, IRS did not formally release the lien against the taxpayer's property until October of the following year—302 days later. Based on the results of our work, we estimate that for over 8 percent of unpaid tax assessment cases where IRS had filed a tax lien that were resolved in fiscal year 2001, IRS did not release the lien within the 30-day requirement.[42] The failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.

[41] GAO-01-394.

[42] We are 95 percent confident that the confidence interval around this estimate ranges from 3 percent to 19 percent.

## IRS's Financial Management Systems Are Not in Compliance with FFMIA Requirements

In fiscal year 2001, we continued to find that IRS's financial management systems did not substantially comply with the requirements of FFMIA. Specifically, IRS's systems did not comply with Federal Financial Management Systems Requirements (FFMSR), federal accounting standards (U.S. generally accepted accounting principles), and the *U.S. Government Standard General Ledger* (SGL) at the transaction level. We found that IRS (1) cannot rely on information from its general ledger to prepare its financial statements, (2) does not have a general ledger that conforms to the SGL, (3) lacks a subsidiary ledger for its unpaid assessments, (4) lacks a reliable subsidiary ledger for its P&E, and (5) lacks an effective audit trail from its general ledger back to subsidiary detailed records and transaction source documents for material balances. Other material weaknesses we discussed earlier—controls over management of unpaid assessments, federal tax revenue and refunds, P&E, budget, and computer security—are also conditions indicating that IRS's systems do not comply with FFMIA.

As a result, IRS's financial management systems cannot produce auditable financial statements and related disclosures that conform with U.S. generally accepted accounting principles without substantial compensating processes and significant adjustments. These weaknesses also indicate that IRS's systems cannot routinely accumulate and report the full cost of its activities. Since IRS's systems do not comply with FFMSR, U.S. generally accepted accounting principles, and the SGL, they also do not comply with OMB Circular A-127, *Financial Management Systems*. In its FIA assurance statement to Treasury, IRS reported that its financial management systems did not substantially comply with FFMIA in fiscal year 2001.

IRS has established a remediation plan to address the conditions affecting its systems' ability to comply with the requirements of FFMIA. This plan outlines the actions to be taken to resolve these issues, designates resources to be devoted to implementing those actions, and specifies time frames for their completion. Due to the long-term nature of IRS's systems modernization efforts, which IRS expects will resolve many of the most serious issues, many of the planned time frames exceed the 3-year resolution period specified in FFMIA. However, for these instances IRS has received a waiver from this requirement from OMB.

# Details on Audit Methodology

To fulfill our responsibilities as the auditor of IRS's financial statements, we:

- Examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. This included testing selected statistical samples of unpaid assessment, revenue, refund, accounts payable, accrued expenses, payroll, nonpayroll, P&E, and undelivered order transactions. These statistical samples were selected primarily to substantiate balances and activities reported in IRS's financial statements. Consequently, dollar errors or amounts can and have been statistically projected to the population of transactions from which they were selected. In testing these samples, certain attributes were identified that indicated either significant deficiencies in the design or operation of internal control or compliance with provisions of laws and regulations. These attributes, where applicable, can be and have been statistically projected to the appropriate populations.
- Assessed the accounting principles used and significant estimates made by management.
- Evaluated the overall presentation of the financial statements.
- Obtained an understanding of internal controls related to financial reporting (including safeguarding assets), compliance with laws and regulations (including the execution of transactions in accordance with budget authority), and performance measures reported in the Management's Discussion and Analysis.
- Tested relevant internal controls over financial reporting (including safeguarding assets) and compliance, and evaluated the design and operating effectiveness of internal controls.
- Considered the process for evaluating and reporting on internal controls and financial management systems under FIA.
- Tested compliance with selected provisions of the following laws and regulations: Anti-Deficiency Act, as amended (31 U.S.C. §1341(a)(1) and 31 U.S.C. §1517(a); Agreements for payment of tax liability in installments (26 U.S.C. §6159); Purpose Statute (31 U.S.C. §1301); Release of lien or discharge of property (26 U.S.C. §6325); Interest on underpayment, nonpayment, or extensions of time for payment of tax (26 U.S.C. §6601); Interest on overpayments (26 U.S.C. §6611); Determination of rate of interest (26 U.S.C. §6621); Failure to file tax return or to pay tax (26 U.S.C. §6651); Failure by individual to pay estimated income tax (26 U.S.C. §6654); Failure by corporation to pay estimated income tax (26 U.S.C. §6655); Prompt payment act (31 U.S.C. §3902); Fair Labor Standards Act of 1938, as amended (29 U.S.C. §206); Civil Service Retirement Act of 1930, as amended (5 U.S.C. §§5332,

5343); Federal Employees' Retirement System Act of 1986, as amended (5 U.S.C. §8423); Social Security Act, as amended (26 U.S.C. §3101 and 42 U.S.C. §430); Federal Employees Health Benefits Act of 1959, as amended (5 U.S.C. §§8905, 8906, and 8909); and Economic Growth and Tax Relief Reconciliation Act of 2001 (26 U.S.C. §6428).

- Tested whether IRS's financial management systems substantially comply with the three FFMIA requirements.

# Comments from the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER

February 19, 2002

Mr. David M. Walker
Comptroller General
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Walker:

Thank you for the opportunity to review and comment on the draft of your report titled, *Financial Audit: IRS' Fiscal Years 2001 and 2000 Financial Statements*. Maintaining the unqualified audit opinion for the annual financial statement for the second year in a row is a significant accomplishment. In this regard, we want to recognize the GAO's dedication and cooperation during this audit. We are grateful for the excellent advice and support your staff provided throughout the process.

As you noted in your letter, the IRS' unqualified opinion on its financial statements is the result of a strong commitment and hard work by management and staff. We agree, and want to reiterate that commitment. We strongly believe that it is essential for a tax agency responsible for collecting over $2 trillion of tax revenue to be able to properly reflect its financial condition.

Our commitment is demonstrated not only by the favorable opinion but also by numerous improvements that we have undertaken. As you reported, we have made notable progress in many areas and have begun to lay the groundwork for sustainable improvements in several others. Specifically, we:

- Implemented a disposal process for property and equipment
- Implemented a process to ensure accruals were adequately reflected as of year-end
- Issued guidance and improved our review of and accounting for open obligations
- Collected and accumulated cost data from existing systems to provide necessary information for decision making and cost management
- Implemented continuity of operations efforts, such as enhanced business systems preparedness and contingency capabilities for potential biohazard threats, at each IRS campus
- Established the Computer Security Incident Response Center, which became operational in FY 2001
- Required all personnel offices to report monthly all individuals who entered on duty prior to a fingerprint result, effective October 2001

The next two major milestones for strengthening our financial operations are Secretary O'Neill's November 15, 2002 audited financial statement goal and implementing our new Integrated Financial System. While pursuing these goals, we are aggressively initiating additional short-term actions that will further improve the timeliness and accuracy of our financial information. Specifically, we plan to:

- Improve guidance to the field about proper classification of property and equipment
- Improve our accrual process in FY 2002 to address timely recording of receipt of goods and services
- Institutionalize periodic reviews of general ledger balances during the year and post adjustments and correcting entries quarterly
- Record imputed costs regularly
- Provide guidance to the field about more accurately reporting revenue activity

While the vast majority of the report is on the mark, we are concerned that a few of the conclusions reached by the GAO overstate our shortcomings. For example, on page 16 of the report, the GAO states the "IRS cannot ensure…that its resources do not exceed budget authority." We clearly have this capability, given that the IRS resources have never exceeded our budget authority. Having said that, we agree with the GAO's findings in this area, but ask it to consider modifying the specific conclusion. Please also reconsider the conclusion drawn under "cost accounting," which is discussed later in this memo. The draft report does not adequately address how we use current cost information in our strategic planning process.

As another general comment, we are concerned that the GAO's references to "workarounds" could be misleading and needs to be clarified. The term "workarounds" could imply that we are bypassing or circumventing proper accounting methods. In fact, we are implementing legitimate, alternative solutions and compensating processes, many of which were discussed with the GAO, to supplement our systems. We are asking that this wording be changed throughout the report.

Additional comments about specific sections of the report are provided as follows:

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**Timeliness**

The GAO states that the IRS was compelled to rely on monumental human efforts "that extended nearly four months after the September 30, 2001 fiscal year-end to derive reliable year-end balances." While we agree considerable effort was needed to produce the financial statements and complete the audit work, the IRS actually delivered financial statements to the GAO on December 14, 2001, two and one-half months after the close of the year. Those statements contained reliable year-end balances.

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**Financial Reporting**

The GAO cites that the Management Discussion and Analysis (MD&A) indicates the IRS is scheduled to replace its current general ledger system with a general ledger that is fully compliant with the requirements of FFMIA by April 2005. The MD&A has been revised to clearly state that Release II of the Integrated Financial System will enable the phased integration of the administrative and revenue general ledgers into a single U.S. Standard General Ledger compliant general ledger. Additionally, under the current Enterprise Data Warehouse Release Plan, subject to Information Technology Investment Account funding availability, the revenue sub ledgers will be completed in Release V, which will extend beyond April 2005.

The GAO also cites that the general ledgers are not supported by adequate audit trails. In prior years, the IRS did not have an obligation subsidiary ledger to support undelivered orders. However, we have since developed a data warehouse for obligations that shows the full transaction history for each obligation, including open obligations and those that have been fully liquidated. The warehouse contains all transactions in the acquisition cycle: obligation, purchasing, receipt, and payment. The subsidiary is updated on a nightly basis and is online for user queries through a web-based interface. We believe this subsidiary satisfies the requirement of providing an adequate audit trail for budgetary activity. Other subsidiary ledgers, with appropriate audit trails, will be built through our systems modernization efforts.

Pages 17 through 20

**Cost Accounting**

The GAO discusses at some length the IRS' inability to make good business decisions on resources due to the lack of a single cost accounting system. We agree we must have an integrated cost accounting system. However, we believe the GAO has overstated the impact of not having such a system. Existing systems are providing adequate cost information for good decision-making. Granted, more work may be necessary to accumulate the data, but it is available and is being used. In FY 2000, the IRS established a strategic planning and budgeting process that allows us to effectively use available cost information to make sound resource allocation decisions. In fact, in the FY 2003 budget, we have identified over $200 million in costs that can be reallocated to top priority customer service and compliance enhancements.

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**Management of Unpaid Tax Assessments**

The GAO cites continuing errors involving the IRS' failure to record payment to all related taxpayer cases (e.g. Trust Fund Recovery Penalty (TFRP)) associated with unpaid payroll taxes. The IRS continues to make incremental improvements in the manual processes while working toward automation. In August 2001, the IRS began to assess these cases separately for each quarter, rather than combining quarters to make one lump-sum assessment. This change should make the cross-referencing process more accurate and easier to complete. As reported in our FY 2000 audit response, we are continuing to develop Phase II of the automation of the TFRP inventory based system that will ensure the timely posting of payments and cross-referencing to all applicable liabilities. A pilot of this phase is scheduled for October 2003.

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**Tax Revenue and Refunds**

The GAO's report does not take into account the necessity of an interview with the taxpayer in many cases to determine Earned Income Tax Credit (EITC) eligibility. The IRS has implemented all legislative authority to immediately correct erroneous EITC claims, either through math error procedures or e-file rejects. For those EITC issues that can only be corrected through deficiency procedures, the IRS has used the special EITC appropriation to examine approximately 500,000 EITC returns each year. Many of these returns are examined prior to the issuance of any refund. Approximately $1 billion is protected or collected through these efforts each year.

We also want to point out the IRS' efforts to prevent erroneous EITC refunds from being issued. Specifically, prior to issuing an EITC refund, the IRS: (1) uses the dependent database, a rule-based system that matches tax return data to third party data and analyzes return characteristics to identify questionable issues relating to the EITC on all returns claiming the EITC; (2) runs all EITC claims through Criminal Investigation's Electronic Fraud Detection System; (3) requires recertification before a taxpayer can claim the EITC on the current tax year if an improper EITC claim was filed in the previous year; (4) bans taxpayers from claiming the EITC for either two or ten years after the tax year when we determined the taxpayer's claim was due, depending on whether there was intentional disregard of the rules and regulations or fraud; and (5) automatically freezes subsequent year refunds where there is already an open examination. In addition, a taxpayer's eligibility for the EITC cannot be determined with certainty by the IRS during the processing of the tax return. Many potential errors can be identified and corrected only by using deficiency procedures.

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**Computer Security**

Although the GAO agrees progress has been made to improve computer security controls, the report indicates significant control weaknesses continue to exist. The IRS continually focuses on its security and privacy responsibilities and strives to enhance and effectively manage its security program. The IRS is also committed to ensuring that effective safeguards over taxpayer data, both electronic and hard copy, are in place. To demonstrate this commitment, we established the Security Executive Steering Committee to oversee and prioritize improvements in the areas of computer security, physical security, and controls over taxpayer receipts. This Committee includes business operating division commissioners and chief officers.

The IRS also continues its efforts on the Technology Security Committee to address improved controls over computer resources such as system programs, files, and data. As noted in your report, this Committee approved standards for the NT and UNIX processing environments. In FY 2002, the Deputy Commissioner for Modernization & Chief Information Officer has committed to ensuring consistent management and implementation of the security controls over IRS' networks and systems. In addition to our efforts already initiated to ensure continuity of operations, we are:

- Developing guidance on defining electronic access to tax processing systems
- Continuing efforts to address the segregation of duties between system and security administration, a requirement in our Law Enforcement Manual
- Improving the monitoring of key systems to identify unauthorized activities and inappropriate system configuration

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**Reportable Condition**

The GAO cites that there are continued weaknesses in the IRS' internal controls over manually processed tax receipts and taxpayer information. Through the IRS' Subcommittee on Security, we focused on improvement in physical security at IRS campuses, field offices, and commercial lockbox banks. The Subcommittee established enhanced controls in the Receipt and Control areas and established routine compliance checks at campuses and field offices. In 2002, the IRS will ensure that enhanced procedures are revisited and employees working in these functions receive additional awareness training. This will include a restatement of our policy regarding the limits established for personal belongings that each worker can bring into receipt processing areas.

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The Subcommittee also established improved security standards for commercial lockbox banks in the new contract, which is currently in place. Among other requirements, these standards require an FBI fingerprint check be performed for each individual who will work in the lockbox processing area. These individuals include temporary agency employees, bank employees, and vendors.

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**Manual Tax Receipts and Taxpayer Information**

In its review of the IRS and Office of Personnel Management (OPM) data, the GAO found that 128 of the over 21,000 individuals hired in FY 2001 began working at IRS facilities prior to the receipt and review of a fingerprint check.

Based on the results of additional inquiries made to IRS personnel offices and OPM, our in-depth review and analysis of the data disclosed that only 52 individuals began to work without a fingerprint check. Of those, 13 were either separated immediately or sent home until fingerprint results were received, thus mitigating any risk that might have been created. In comparison, for FY 2000, the GAO reported that 4,900, or 25 percent, of 19,600 hires entered on duty without a fingerprint result. In FY 2001, those entering on duty without a fingerprint result represented less than ¼ of one percent of all hires. This is overwhelming proof of the improvements the IRS has made in this area and that taxpayer returns and sensitive data are not placed at risk.

To further improve compliance with fingerprinting policy we plan to:

- Develop a database to provide personnel offices and applicants with information regarding sources, other than IRS personnel offices, where fingerprints can be taken
- Conduct training for personnel involved in the fingerprinting and background investigation process

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**IRS Did Not Always Release Federal Tax Liens in Accordance with the Internal Revenue Code**

The GAO says the IRS did not release liens within the 30-day requirement. We reviewed the cases cited. Although we have not been able to fully determine the "root" cause of delayed lien releases, the majority of the cases have a freeze condition and/or credit transfer which prevented the release of the lien. In response, we initiated a program change to bypass certain freeze conditions so the master file will notify the lien

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system at an earlier point in time of the satisfaction of the liability. We will continue our research to determine other ways to improve this process.

This completes our specific comments.

In closing, I believe the IRS has demonstrated its commitment to improving financial management. We are taking, and will continue to take, the appropriate and necessary actions to improve processes and current systems while moving aggressively on our systems modernization effort. Both the GAO and the IRS recognize that it is only through implementation of the new integrated financial management system that we will be able to overcome the majority of the material weaknesses cited in your report.

Sincerely,

Bob Wenzel

Bob Wenzel

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